

Four Dollars

T H E

Winter / Spring 1986

BROOKINGS

R E V I E W

*Barry P. Bosworth on Fiscal Fitness:
Deficit Reduction and the Economy*

Economics of Corporate Takeovers

*Douglas H. Ginsburg and John F. Robinson
on the Case Against Federal Intervention*

F.M. Scherer on the Dangers of Takeovers

*Paul E. Peterson
on Commissions on Higher Education*

*Frank M. Coffin
on Relations Between the Judiciary and Congress*

*Martha Derthick
on the Supreme Court and Federalism*

Board of Trustees

Robert V. Roosa

Chairman

Louis W. Cabot

Vice Chairman

Chairman, Executive Committee

Ralph S. Saul

Vice Chairman

Chairman, Development Committee

Samuel H. Armacost

J. David Barnes

Rex J. Bates

Frank T. Cary

A. W. Clausen

William T. Coleman, Jr.

Lloyd N. Cutler

Thomas R. Donahue

Charles W. Duncan, Jr.

Walter Y. Elisha

Robert F. Erburu

Roberto C. Goizueta

Hanna H. Gray

Robert D. Haas

Philip M. Hawley

Amory Houghton, Jr.

Roy M. Huffington

B. R. Inman

James T. Lynn

Bruce K. MacLaury

Donald F. McHenry

Robert S. McNamara

Mary Patterson McPherson

Donald S. Perkins

J. Woodward Redmond

James D. Robinson III

Henry B. Schacht

Howard R. Swearer

Morris Tanenbaum

Phyllis A. Wallace

James D. Wolfensohn

Ezra K. Zilkha

Charles J. Zwick

Honorary Trustees

Vincent M. Barnett, Jr.

Barton M. Biggs

Eugene R. Black

Robert D. Calkins

Edward W. Carter

Bruce B. Dayton

Douglas Dillon

George M. Elsey

Huntington Harris

Andrew Heiskell

Roger W. Heyns

John E. Lockwood

William McC. Martin, Jr.

Arjay Miller

Charles W. Robinson

H. Chapman Rose

Gerard C. Smith

Robert Brookings Smith

Sydney Stein, Jr.

THE BROOKINGS INSTITUTION is a private nonprofit organization devoted to research, education, and publication on important issues of domestic and foreign policy. Its principal purpose is to bring knowledge to bear on the current and emerging policy problems facing the American people. Brookings functions as an independent analyst and critic, committed to publishing its research findings for the information of the public. In its educational activities, it works to bridge the gap between scholarship and policy-making, bringing new information and analyses to the attention of decision-makers in the public and private sectors. Its activities are carried out through three research programs (Economic Studies, Governmental Studies, Foreign Policy Studies), a Center for Public Policy Education, a Social Science Computation Center, and a Publications Program.

The Institution was incorporated in 1927 to merge the Institute for Government Research, founded in 1916 as the first private organization devoted to public policy issues at the national level; the Institute of Economics, established in 1922 to study economic problems; and the Robert Brookings Graduate School of Economics and Government, organized in 1924 as a pioneering experiment in training for public service. The consolidated institution was named in honor of Robert Somers Brookings (1850 – 1932), a St. Louis businessman whose leadership shaped the earlier organizations.

Brookings receives financial support from philanthropic foundations, corporations, and private individuals; it also draws funding for its activities from endowment income, conference fees, sales of publications, and charges for computer services. In addition, the Institution undertakes some unclassified government contract studies, reserving the right to publish its findings.

A board of trustees is responsible for general supervision of the Institution, approval of fields of investigation, and safeguarding of the Institution's independence. The president is the chief administrative officer, responsible for formulating and coordinating policies, recommending projects, and selecting the staff. In recent years the senior fellows and research associates have numbered about fifty men and women with varied backgrounds in the academic world, government, or both.

The officers and staff conduct a continual review of the Institution's fields of interest. Discussion with government officials, members of Congress, business leaders, foundation officers, and other scholars help to identify issues for study. Subjects are selected for study on the basis of their significance and timeliness, the adequacy of information and techniques of investigation, the availability of personnel and funds, and the relationship of the projects to the Institution's objectives. Each Brookings study is offered as a competent scholarly treatment of a subject worthy of public consideration; the Institution itself does not take positions on policy issues.

T H E
BROOKINGS
R E V I E W

Winter/Spring 1986, Vol. 4, No. 2

3 Fiscal Fitness: Deficit Reduction and the Economy

Barry P. Bosworth

*Economics
of Corporate Takeovers*

**9 The Case Against Federal Intervention in the Market
for Corporate Control**

Douglas H. Ginsburg and John F. Robinson

15 Takeovers: Present and Future Dangers

F.M. Scherer

21 "Commissionitis" in Higher Education

Paul E. Peterson

**27 The Federalist on Relations Between the Judiciary
and Congress**

Frank M. Coffin

**32 Preserving Federalism: Congress, the States,
and the Supreme Court**

Martha Derthick

38 At Brookings

Darman speaks at board of trustees dinner. New York meeting with business leaders. Conference on administration of justice. Hills named vice president.

41 New Publications

William B. Quandt on Camp David Accords. James L. Sundquist on constitutional reform. Jerry F. Hough on third world policy. William W. Kaufmann on defense. Robert W. Crandall, Howard K. Gruenspecht, Theodore E. Keeler, and Lester B. Lave on auto regulation. R. Kent Weaver on industrial policy.

Brookings Books

Camp David: Peacemaking and Politics

William B. Quandt 1986/\$12.95 paper/\$32.95 cloth

The Struggle for the Third World: Soviet Debates and American Options

Jerry F Hough 1986/\$12.95 paper/\$32.95 cloth

A Reasonable Defense

William W. Kaufmann 1986/\$8.95 paper

The Calculus of Conventional War: Dynamic Analysis without Lanchester Theory

Joshua Epstein 1985/\$5.95 paper

Regulating the Automobile

Robert W. Crandall, Howard K. Gruenspecht, Theodore E. Keeler, and Lester B. Lave 1986/\$10.95 paper/\$28.95 cloth

Trends in American Economic Growth, 1929-1982

Edward F. Denison 1985/\$11.95 paper/\$31.95 cloth

Energy Conservation: Successes and Failures

John C. Sawhill and Richard Cotton, editors 1986/\$10.95 paper/\$28.95 cloth

Biotechnology: Implications for Public Policy

Sandra Panem, editor 1986/\$10.95 paper

Constitutional Reform and Effective Government

James L. Sundquist 1986/\$9.95 paper/\$26.95 cloth

Religion in American Public Life

A. James Reichley 1985/\$11.95 paper/\$31.95 cloth

The Politics of Industrial Change: Railway Policy in North America

R. Kent Weaver 1985/\$11.95 paper/\$31.95 cloth

The Brookings Review is published quarterly by the Brookings Institution, 1775 Massachusetts Avenue, N.W., Washington, D.C. 20036. Second-class postage paid at Washington, D.C. Copyright © 1986 by The Brookings Institution. All rights reserved.

President: Bruce K. MacLaury
Vice President — External Affairs:
 John M. Hills
Public Affairs Director:
 Margaret M. Rhoades

The Brookings Review
Publisher: Mark Goldberg
Editor: Martha V. Gottron
Program Assistant: Katharine Beckman
Production Staff:
 Vickie L. Corey
 C. Elizabeth Warner
 Julie Bailes Legg
Proofreader: Mary Umberger

Designed by Meadows & Wiser

Second-class postage paid at Washington, D.C.
 USPS I.D. No. 14209; Publication No. 551640;
 ISSN 0745-1253
 Subscription rates:
 one year, \$15 (\$20 foreign);
 two years, \$27 (\$37 foreign).
 Send address changes to:
The Brookings Review
 1775 Massachusetts Avenue, N.W.
 Washington, D.C. 20036

No. Copies	Author	Title	Price
			\$

Postage and Handling **2.00**

Total \$

_____ Payment enclosed Bill to my _____ MasterCard _____ VISA

_____ Exp. date _____

Signature _____ Phone # _____

Name _____

Address _____

City _____ State _____ Zip _____

Mail to: Cashier's Office
 The Brookings Institution
 1775 Massachusetts Avenue, N.W.
 Washington, D.C. 20036

XREV42



Fiscal Fitness: Deficit Reduction and the Economy

Barry P. Bosworth

THE Gramm-Rudman-Hollings act has initiated a major new round of debate in Washington over budget policy. Thus far, however, the focus of attention has fallen on the implications of expenditure reductions in individual programs and the possibility of a tax increase. Less attention has been paid to the challenges that the deficit reduction law raises for the monetary authorities as they attempt to maintain a non-inflationary expansion of the domestic economy. This is also the first time in over four years that the United States is seriously contemplating a reversal of a fiscal policy that has been consistently stimulative on the demand side of the economy.

Can the United States make the transition to a more prudent pay-as-you-go budget policy without precipitating a recession or a resurgence of inflation? I believe that the answer to that question should be yes and that the economic situation in 1986–87 provides close to the ideal environment in which to begin that adjustment. That conclusion, however, is highly dependent upon the clear recognition that what is needed is a shift in the policy mix—a tighter fiscal policy offset by an easing of monetary policy—and not just a reduction in the budget deficit. Eliminating the deficit in five years, as the Gramm-Rudman-Hollings act proposes, would place a heavy burden on the Federal Reserve to sustain the economic expansion. Implementing that law is risky, but it is less risky than the current stalemate between the president and Congress in which nothing is done.

This paper addresses the consequences of a reduction in the budget deficit along the lines envisioned in Gramm-Rudman-Hollings through an examination of a series of subsidiary questions.

- What is the outlook for the economy in the absence of fiscal policy changes?
- What should be the long-run target for reductions in the budget deficits?
- What are the major adjustment problems that we face if the deficit reductions actually occur?

Current Outlook

For over four years, the United States has been in the midst of a self-indulgent national consumption boom, financed by net borrowing abroad. Today the United States consumes 96.6 percent of its annual income, leaving it with the lowest rate of national saving and investment since World War II. In 1984 and 1985, the federal budget deficit absorbed over 60 percent of net private saving. It has proved possible to finance this situation only by borrowing an incredible 3 to 4 percent of the annual national income overseas. Thus, for example, the United States is experiencing a quite normal rate of domestic investment—the only change is that it is investment by foreigners, not Americans, and they will receive most of the future benefits in interest and dividend payments.

Barry P. Bosworth is a senior fellow in the Economic Studies program at Brookings. Bosworth is the author of Tax Incentives and Economic Growth and is currently engaged in a study of international imbalances in savings and investment. An earlier version of this paper was prepared for the House Budget Committee.

When the less-developed countries encountered debt-repayment problems in the early 1980s, our government counseled them to tighten an already short belt and live within their means. We should now take a little of our own advice.

It has proved almost impossible, however, to convince the average American that this foreign debt constitutes a serious problem. Because of it they get to keep their favorite expenditure programs, while taxes stay low. The cost of the foreign borrowing lies many years in the future and the need to repay the debt is simply not an issue of public concern. Still, it is worth recalling the major long-term costs of the current policies.

The foreign debt is growing at about \$125 billion annually and obligates future generations to interest and principal repayments that will mount steadily in future years. An overvalued dollar, created by the need to borrow overseas, has drastically reduced the competitiveness of American industry in world markets. The United States now has a trade deficit in every major industrial product line, including even such high technology industries as computers. The exchange rate is also a major factor behind the collapse of American agriculture, making the United States a high-cost producer in world markets. And there is an increasing shortfall of domestic production in the export- and import-competing industries as facilities are being moved overseas.

Both the accumulation of debt and the loss of the industrial base imply that the longer we wait, the larger will be the fall in the value of the dollar. A lower exchange rate will be required to earn the foreign exchange needed to pay interest on the debt and to rejuvenate domestic capacity in the tradeable goods industries. The decline in the exchange rate will add to domestic inflation pressures. Moreover, there is a risk, currently small, of a sudden and major collapse in the exchange rate if foreigners come to question the future viability of the U. S. economy.

These problems, however, imply that the cost of the current consumption binge lies largely in the future. The near-term outlook, as reflected in the Congressional Budget Office (CBO) forecast, is for a continued modest growth of the U.S. economy of about 3–4 percent annually, fueled in part by the budget deficit, which provides a sustained, high level of stimulus to the domestic economy. While monetary policy is the only available tool for controlling overall economic performance, it is in an unusually strong position.

The high level of interest rates has led to a substantial backlog of pent-up demand, and monetary policy can operate essentially as a brake on a buoyant domestic economy, clamping down when demand growth threatens to accelerate, and letting up when growth begins to slow. The trade balance has emerged as a major new channel through which monetary policy, in its effect on the exchange rate, can influence overall economic activity. Inflation should continue to remain low, as the Federal Reserve Board seems intent on maintaining domestic unemployment well above 6 percent and falling commodity prices provide a negative impact on the price level.

Current monetary policy seems to be aiming for a growth rate in the gross national product consistent with nonacceleration of inflation — approximately 3 to 4 percent annually. When growth threatens to slow, policy eases and interest rates decline. When growth accelerates, policy

tightens and interest rates tend to rise. This policy has worked well because the Federal Reserve has not been faced with a crisis, such as a collapse of the exchange rate, that would force it to choose between competing economic goals and because the public has been willing to support a continued high level of unemployment to hold down inflation. The Fed still has room to maintain the expansion by allowing interest rates to drift down to more normal levels.

In summary, the debt-generating policies of the United States are bound to lead to a day of reckoning, but no one has the basis to predict precisely when it will actually occur. In the meantime, a policy that promotes domestic consumption, while leaving the financing of investment to foreigners, has proved to be highly popular.

What Should Be the Goal of Fiscal Policy?

The Gramm-Rudman-Hollings law specifies a path for gradually reducing the budget deficit to zero by the year 1991. The idea of gradual adjustment makes sense because after four years both the United States and the world economy have adapted to a large U.S. budget deficit. The move back towards balance will be as wrenching in its impact on the economic structure as the original creation of the imbalance. A reduction in the budget deficit will have a deflationary effect on demand in domestic economy, and because of lags, it will take time for monetary policy to provide the needed offsets. Other countries have become highly dependent upon an excess of exports to the United States as a source of stimulus to their own economies. They too will need time to adjust. Furthermore, the inflationary impact of a decline in the exchange rate, higher import prices, may be easier to absorb if it is spread over several years.

Still it is important to distinguish between the short-run adjustment problems—the need for a flexible fiscal policy to absorb unanticipated changes in private demand—and the long-run target for fiscal policy. The issue of long-term targets is most easily addressed within the context of the balance of the nation's saving and investment.

Restoring Saving, Investment Balance

A summary of recent trends in national saving and investment is shown at the top of the accompanying table. The national rate of saving and investment has declined precipitously in the 1980s from a historical average of about 8 percent of national income to less than 4 percent.¹ That decline is almost entirely due to an increased rate of dissaving by government—private saving continues to represent a share of national income that is close to the postwar average. The impact on domestic investment of the collapse of national saving has been buffered to a surprising degree by an inflow of borrowed resources from abroad. In just a few brief years the United States has liquidated a stock of foreign assets built up over the prior half century and is now a net debtor nation.

Over the last decade U.S. policy-makers have bickered endlessly over the structure of the tax system and its implications for domestic capital formation. Today Congress is engaged in another round of debate over tax policy, a debate in which the impact of taxes on investment demand

again plays a prominent role. Yet, it does no good to seek means of promoting domestic investment if the nation is unwilling to supply the saving to finance it. Without an increase in the national saving, every dollar in increased domestic investment will be financed by an equal increase in the current account deficit with other countries. That foreign borrowing is already equivalent to about half of net domestic investment (3.1 percent versus 6.5 percent of national output in 1985). Today domestic investment is limited by the shortage of domestic saving and the high exchange rate that goes with it, not taxes.

Domestic financing of capital formation must come either from increases in private saving (households and businesses) or from a reduction in government dissaving (the budget deficit). In recent years we have given away billions in tax incentives to promote private saving. It is now about time to conclude that those policies have failed: There has been no rise in the private saving rate despite tremendous increases in the after-tax return to holders of capital assets.² If the United States is serious about increasing the national rate of saving and investment, it must do so by reducing the budget deficit.

Various rates of net capital formation that could be expected under alternative budget policies are outlined in the table. Throughout I assume that monetary policy will be conducted to maintain the economy along a high employment path. I also assume that the private sector saving rate recovers to 9 percent of net national product (NNP), the average of the prior three decades, and that the United States returns to a balance in its current account.³ I do not go so far as to assume that the foreign debt, run up during the 1980s, is repaid.

Given these assumptions, it is possible to estimate the resources available to finance domestic investment for sev-

eral alternative budget deficit targets. As a point of departure, the CBO projects a steady decline in the deficit, under current policies, to 1.7 percent of GNP in 1991. On a national accounts basis, that would translate into about 2 percent of NNP and a national saving rate of 7 percent. Assuming that the United States does not continue to borrow abroad, that budget strategy would allow a slight rise in the net rate of capital accumulation from 6.5 percent of NNP in 1985 to 7 percent in the early 1990s. As the table shows, however, that rate is below the levels of prior decades.

A budget deficit of zero in 1991 — the Gramm-Rudman-Hollings objective — would allow the investment share to rise above the historical average to about 9 percent of NNP. Such an investment rate would be close to that achieved during past periods of strong economic activity, such as the mid-1960s, 1972–73, and 1977–78.

An alternative, often discussed by economists, would be to have a balanced budget adjusted for inflation. That is, account would be taken of the decline in the real value of the public debt due to inflation. Such a target would imply a budget deficit of 1.3 percent of NNP at a 4 percent inflation rate in 1991. The deficit target is, coincidentally, equivalent to the average historical experience.

Funding Social Security

However, I fail to see why we should aim for nothing better than the average of the past. An increased rate of capital formation would yield substantial social benefits to the United States, and the historical average to which we might aspire frequently has been held down by recession. Furthermore, in one important respect the projections of the budget understate the magnitude of the deficit problem.

Table 1. Saving and Investment as Shares of Net National Product, 1951–85

Period	National Saving			Investment	
	Private	Government	Total	Net Foreign	Domestic
1951–60	8.4%	–0.7%	7.7%	0.3%	7.4%
1961–70	9.2	–1.0	8.1	0.6	7.6
1971–80	9.7	–2.0	7.7	0.3	7.4
1981–1985	8.6	–4.7	3.9	–1.3	5.2
1985	8.8	–5.4	3.4	–3.1	6.5
Budget Options for 1991					
CBO Baseline	9.0	–2.0	7.0	0.0	7.0
Gramm-Rudman-Hollings	9.0	0.0	9.0	0.0	9.0
Inflation-Adjusted Balance	9.0	–1.3	7.7	0.0	7.7
Unified Budget Balance	9.0	1.0	10.0	0.0	10.0

Source: U.S. Department of Commerce and author's estimates. Net saving and investment equal the gross flow minus capital consumption allowances (the depreciation of existing capital). Net National Product equals GNP minus capital consumption allowances. Private saving is business and household saving. Pension funds of state and local government employees are allocated to private saving. Figures may not add due to rounding.

"We should not forget that the current deficit is in excess of \$200 billion annually, and it will stay in that range unless Congress and the president enact wrenching changes in existing spending and taxation patterns."

In its retirement programs the United States does not fully fund the future liability (retirement costs) of each generation, preferring instead a partial pay-as-you-go system by which current workers devote a share of their income to help finance the currently retired in return for an equal treatment when they retire. These two systems are roughly equivalent when the retired are a constant share of the population. But when the retired rise as a proportion of the total population, which is expected to happen after the year 2020, there is an extra burden placed on future workers who must devote a larger share of their incomes to support the elderly.

In recognition of this problem, Congress acted in 1983 to reduce future social security benefits and to increase taxes on current workers. The objective was to reduce the extra burden on future generations by increasing saving of the current generation, investing in a larger stock of capital, and raising national income in future years. In effect, the current generation would pay a portion of its own retirement costs, equivalent to the anticipated rise in the proportion of the future retired population, thus absorbing the extra cost to future workers. As a result, the social security system will run a substantial surplus for the next three decades, accumulating to about \$12 trillion in the year 2030, and declining rapidly thereafter as the number of retirees increases. If, however, the surplus in the trust fund is used to finance the deficit in the rest of the budget, that is, the consumption of the current generation, no future benefit is obtained. In effect, the United States would simply be using a regressive wage tax to finance programs, such as defense, of benefit to the general population.

By the 1990s this extra saving in the trust fund will average about 1 percent of GNP. Thus, validation of the 1983 social security amendments requires that the United States aim for a total budget deficit that is smaller by about 1 percent of GNP than it would otherwise be. This is a more ambitious target for the budget than the historical record or that proposed by Gramm-Rudman-Hollings.

As shown at the bottom of table 1, if the social security fund is not used to support the consumption of the current

generation, the total budget would show a surplus equal to one percent of NNP. As a result, national saving would be sufficient to support a potential net investment share equal to 10 percent of NNP. While such an investment rate has been achieved only rarely and then only at the peak of historical business cycles in the United States, it would largely eliminate the extra burden imposed by the growth of the retired population in future decades.

This highly simplified exercise for projecting trends in the national saving-investment balance nonetheless illustrates the substantial capacity the United States has to adjust successfully to a wide range of alternative budget strategies.⁴ I also believe it is a strong argument in favor of a higher rate of national saving and investment than the United States has had in the past. If we do not intend to finance a higher rate of capital formation, why do we waste so much time arguing over tax incentives for investment?

Finally, Congress should not be misled into believing that the Gramm-Rudman-Hollings targets will be easy to achieve because of the declining deficits embedded in both the administration's and CBO's current service projections. Budget projections require assumptions, and, if you make enough of them, you can get any deficit you want. CBO, for example, decided this year to change its previous assumption that defense spending would grow at an annual real rate of 5.5 percent. It now assumes zero growth after inflation. While the assumed 5.5 percent was absurdly high, I know of no actions or plans by Congress or the administration that would make the zero real growth consistent with current defense policy. Similarly, both CBO and the Office of Management and Budget embedded the first stage cuts of Gramm-Rudman-Hollings into the baseline projections for nondefense spending, while only CBO produced a meaningful baseline for defense. Both also assume a continued decline in interest rates, and thus debt service costs, that is likely to result only if the deficit reductions actually occur.

We should not forget that the current deficit is in excess of \$200 billion annually, and it will stay in that range unless Congress and the president enact wrenching changes in existing spending and taxation patterns. We are seeking to

"The rigidity imposed on fiscal policy by the fixed targets of Gramm-Rudman-Hollings is a serious problem. It puts a major responsibility on the monetary authorities who are being asked to undertake an active policy to offset fiscal restraint. . . ."

reduce the deficit by a full five percentage points of GNP over a five-year period — doubling our national saving rate. That will be very difficult to achieve.

Adjusting to a Smaller Deficit

Tax increases or cuts in budget outlays will have an unambiguously depressive effect on the domestic economy in the short run. The key to avoiding slower economic growth is prompt and strong action by the monetary authorities to promote an offsetting rise in private spending. An easing of monetary policy would have positive effects on homebuilding, business investment, and consumer durables. But stronger domestic demand alone will not be enough. The major adjustment lies with the decline in the exchange rate and a smaller foreign trade deficit — larger exports and fewer imports.

The Gramm-Rudman-Hollings act calls for a reduction in the budget deficit that totals 5.5 percent of NNP between 1985 and 1991. To sustain the expansion, private demand must rise by an equal offsetting amount. Elimination of the current account deficit with other countries would provide three percentage points, leaving 2.5 percent of output to be absorbed by a higher level of domestic investment. The improvement of the current account will require the exchange rate to fall back at least to the levels of 1980 and perhaps below; the rise in investment will require a decline in interest rates well beyond what has already been achieved.

Calendar years 1986 and 1987 are an ideal time to begin this process because: (1) lower interest rates will improve the health of the financial system, benefiting financial intermediaries, agriculture and the debtor nations, and (2) falling oil prices will provide some offset to the inflationary pressures that can be expected to follow a decline in the exchange rate. It is much better to begin the process of adjusting the budget in a strong economy rather than waiting for the problems to manifest.

The adjustment is made more difficult because of uncertainties over what deficit reduction actions will be taken and when. The offsetting change in monetary policy can be

expected to operate with a considerable lag. Yet, it is likely to be October 1986 — the beginning of the new fiscal year — and perhaps later before the Fed knows precisely what fiscal actions will be taken. In other words, a coordinated shift in the policy mix might be difficult to arrange.

A second concern lies with the anticipated decline in the exchange rate. In past years a growing trade deficit provided the major response to the growing budget deficit. So too, as the process reverses, the trade deficit must decline. An improved trade deficit is expected to provide over half of the offset to reduced fiscal stimulus. If, however, other countries resist the decline in the dollar, the expected improvement in the trade deficit may not materialize. The further decline in U.S. interest rates, which is expected to follow a shift in the fiscal-monetary policy mix, will result in lower rates in other countries, and that alone should benefit their economies. Higher growth abroad would, through an income effect, improve U.S. export performance. But the United States also needs the improvement in competitiveness that would accompany a return of the exchange rate to more normal levels. Thus, other countries must be willing to allow the dollar to decline and to replace the stimulus that they now receive from exports to the United States with domestic measures.

I am cautiously optimistic that this will occur. Lower oil prices and a lower value of the dollar provide Europe in particular with an excellent opportunity to aim for higher growth — inflation will be much less of a constraining influence. In the first half of the 1980s many European countries focused on reducing their own budget deficits, which had grown enormously during the late-1970s. For many of these countries, that goal has now been achieved. Simply returning the fiscal policy to a more neutral stance should provide an opportunity for faster growth within Europe as a whole.

The rigidity imposed on fiscal policy by the fixed targets of Gramm-Rudman-Hollings is a serious problem. It puts a major responsibility on the monetary authorities who are being asked to undertake an active policy to offset fiscal restraint rather than react passively to developments. If the United States should encounter a major exchange rate crisis,

the Federal Reserve may be tempted to abandon the goal of domestic balance in favor of an emphasis on external balance. The United States could be caught attempting to achieve two contradictory goals with a single policy tool. Under the deficit reduction law, there is only a limited ability to adjust the fiscal targets to unforeseen economic circumstances. Apparently that risk is necessary to force action by the president and Congress. Failing to reduce the deficits also has high risks.

Alternative Budget Reduction Strategies

Choosing which specific budget actions should be taken to reduce the deficit is primarily a political task, not an economic one. Nonetheless, the debate raises some concerns.

First, the discussion about the implications for investment of any increased taxation of capital income needs to be broadened. Taxes do affect investment decisions, but often too much attention is devoted to that issue alone, while other equally important factors are ignored. Today investment is being driven offshore by high financing costs and an exchange rate that makes it impossible for many domestic industries to compete in world markets. Much more can be done to provide for more capital formation through efforts to reduce the federal deficit, interest rates, and the exchange rate. The benefits of that policy will accrue to a much wider group than those who might benefit from a few more special provisions for the taxation of capital income.

While Congress is bombarded with further requests to exempt certain types of capital income from taxation, it should remember that it is the tax on labor income, not capital, that has risen in recent decades. Tax relief for one group must be paid for by others; and, while taxes distort saving and investment decisions, they also distort work effort. The issue of whether economic growth would be

increased by a shift of taxes from capital to labor is very complex — particularly in an open economy with international capital markets — and I do not believe that any economist knows the answer. Basically, the choice between tax increases and expenditure reductions is a vital political issue; but, within the range of change under discussion, the economic effects of either choice are secondary to the effects of reducing the deficit itself.

Second, budget targets should not be met by a series of financial gimmicks that simply manipulate the totals of the budget without altering its economic effects. For example, it has been proposed that the government could meet the deficit targets by selling some of its financial assets. As each of us is aware in managing our own budgets, the sale of a financial asset is simply a substitute for issuing more debt. Such a transaction would have no effect on the national balance of saving and investment outlined earlier.

Third, allowing the mandatory cuts imposed by Gramm-Rudman-Hollings to occur may be a reasonable starting point for deficit reduction, particularly if tax increases are to be ruled out by presidential veto. Some of the cuts will seem unreasonable, but nothing in the act prevents the president and Congress from restoring some of those cuts so long as they provide the revenue to pay for them. The budget that emerges from the mandatory cuts is not final, and it seems to me as good a basis for consideration of alternatives as any other.

Finally, the 1983 agreement on social security could serve as the model for a process by which Congress might proceed to restore balance between outlays and taxes. Given a financing crisis, Congress cut benefits to future retirees and raised taxes. The benefit of a trust fund arrangement is that it forces simultaneous decisions on providing benefits and paying for them. The social security trust fund is now in a substantial surplus position and is not a cause of the budget deficit. In fact, as mentioned earlier, it is being used to finance consumption in other areas.

A similar approach might be applied to other areas of the budget, such as defense and medical care. Each program could be allocated a portion of the deficit in proportion to its share of total outlays — a reasonable, although arbitrary, point of departure. Congress would then be required to vote a combination of outlay reductions or tax increases for each program equal to its share of the budget deficit. The basic principle is simple: If you want it, you must pay for it.

“Finally, the 1983 agreement on social security could serve as the model for a process by which Congress might proceed to restore balance between outlays and taxes.”

1. The decline in the rate of saving and investment seems particularly incongruous given the supply-side rhetoric of the early 1980s when the Reagan administration condemned the supposedly consumption-promoting policies of the past and promised large gains in the national rate of capital formation.

2. It is sometimes argued that the budget deficit is of no real concern because private saving will adjust automatically to leave the national saving rate unchanged. Clearly, that has not happened in the 1980s.

3. The employee pension payments of state and local governments have been allocated to the income and thus the saving of their employees, the same treatment as is used for private pensions. As a result the budget of state-local governments is essentially balanced.

4. The calculations probably overstate the change in domestic investment by excluding adjustments in other components. A 10 percent national saving rate, for example, would probably produce a current account surplus — overseas investment.

The Case Against Federal Intervention in the Market for Corporate Control

Douglas H. Ginsburg
and
John F. Robinson

The recent surge of corporate mergers, marked by a high incidence of hostile takeovers involving some of the nation's largest corporations, has raised two broad questions: Are corporate takeovers good or bad for the economy? Should the federal government intervene in the acquisition process?

In December the Brookings Center for Public Policy Education gathered together a group of corporate, financial, government, and legal leaders to discuss their concerns about takeovers. The following two articles were prepared at the Review's invitation by participants in that conference.

WITH ONE notable exception, the United States has traditionally relied on the owners of the business — the shareholders — to decide whether a proposed business combination should take place. The exception is for mergers that are likely to have serious anticompetitive effects, that is, where there is a strong public interest in the outcome because the companies would be able to charge monopolistic prices. Federal law charges two agencies, the Department of Justice and the Federal Trade Commission, with the duty to investigate and prevent combinations that seriously threaten competitive harm. Apart from that narrow exception, which is outside the scope of this article, Congress has consistently sought to be scrupulously neutral, neither encouraging nor discouraging mergers that are not anticompetitive.

Some argue that it is now time for the government to abandon its neutral stance and enter the fray. These critics and the popular press breathlessly report that we are embarked on an era of skyrocketing "merger mania" that will harm the economy if left unchecked. Recent statistics on mergers help put our present situation in perspective. The number of transactions (measured broadly to include divestitures and "going private" transactions) was about 3,000 in 1985, approximately 20–25 percent more than the relatively constant number of transactions each year between 1975 and 1984. The largest number of transactions occurred, however, in 1968: 6,107, or twice the 1985 level. Moreover, during each of the seven years from 1967 to 1973, the level of transactions equaled or exceeded the 1985 level.

The number of transactions is only part of the story, of course. An important change has occurred in the dollar volume of such transactions and, in particular, the number of very large companies that now are being acquired or are going private. The first \$1 billion transaction was in 1970; by 1978, only four more deals of that size were concluded. In contrast, 18 such deals (three of them over \$5 billion) were completed in 1984 and 24 in 1985. Even after adjusting for inflation, the 1985 dollar volume now exceeds the prior peak in 1968 by about 40 percent.

While these statistics may or may not suggest a merger mania, they certainly help explain why the subject is receiving so much attention. It is no longer a

Douglas H. Ginsburg is Assistant Attorney General, Antitrust Division, Department of Justice. John F. Robinson is a senior staff member of the Office of Management and Budget.

*"It is not possible to say,
however, that all, or even most,
transactions of a particular type
are harmful"*

simple matter of big companies acquiring small ones. Some of the country's largest and most familiar companies are being acquired, restructured, or taken private. Large numbers of shareholders and employees are being affected. And the professional managers of the Fortune 500 companies have discovered that the massive size of the companies they manage is no longer a prohibitive barrier to shareholder challenges to their control through a "hostile takeover"—an acquisition that is opposed by the management of the target company.

Although most of the public debate has focused on hostile takeovers of large companies, only five of the 24 \$1 billion transactions in 1985 arose from hostile takeover attempts. It should not, however, be surprising that hostile takeovers spark the most intense interest; conflict is more dramatic news than concord. Also, managers of large corporations are speaking out against the possibility of challenges to their control now that they find themselves vulnerable to being on the wrong side of a takeover challenge. Indeed, a coalition of corporate executives recently formed "Stakeholders in America" to oppose hostile takeovers. And some managers have resorted to extreme and even destructive tactics in their attempts to fend off such challenges.

Benefits, Costs, and Public Policy

Not even managers who oppose hostile takeovers dispute that mergers in general can and often do benefit the economy. They can directly increase the country's wealth and productivity. Mergers can result in joint operating efficiencies that enable the same products or services to be delivered at a lower cost. They can make it possible to realize economies of scale or scope, as well as financial economies. They can provide both the acquiring and target companies with resources—capital, management, or technology—that lead to new or better products than either company could have developed independently.

Mergers and takeover attempts, even unsuccessful ones, can also identify undervalued assets, causing them to be more appropriately valued or to be redeployed in a more valuable use—an extremely important function for the economy's productivity. Acknowledging such a role for takeovers does not imply that the managers of companies that are takeover targets are either lazy or stupid. The available evidence indicates they are not. It merely requires one to believe that they are not perfect and that it is possible for someone else to make a company's assets still more valuable to shareholders, even if the company has been a strong performer in its industry. Disagreement over this point is at the root of the debate over whether hostile takeovers are good for the economy or not.

Hostile takeovers perform another very important function for the economy, one that is different from the friendly merger. They provide an antidote to the "agency problem" that is associated with widely held public corporations. The agency problem stems from the sometimes significant divergence of interests between the owners—that is, the shareholders—and the managers who, as the owners' agents, run the corporation. Because the shareholders find it difficult and costly to act in concert, and the managers are able to use the resources of the corporation to defend their position, it can be prohibitively expensive and time consuming for shareholders to replace their management by use of the proxy machinery.

The hostile takeover attempt can be the only effective way for the shareholders to overcome the agency problem and receive full value for their ownership of the corporation. It is also often the most efficient way in which a competing management team can "go over the heads" of incumbent managers and make its case directly to the shareholders. More important, while an actual takeover provides such a remedy, even the threat of a hostile takeover attempt can be an effective incentive for incumbent managers to review their operations continually and to make sure they are getting the most value out of the assets they are charged with managing.

Notwithstanding the good for the economy that can come from mergers—hostile and friendly—a merger can also destroy wealth by moving assets to less efficient hands. We saw examples of such errors during the conglomerate building era of the late 1960s and early 1970s. We are witnessing the fallout from that period in the divestiture programs that many companies have now begun in order to focus their energies and resources on the businesses they know best. Indeed, about one-third of today's corporate acquisitions involve a seller divesting a firm acquired at an earlier time. But these examples simply illustrate the fact that sometimes business people err, which is neither surprising nor avoidable.

Because many mergers and acquisitions may not deliver the efficiency-enhancing gains that were originally expected by the parties involved—indeed some have resulted in significant losses—some have suggested that the federal government should step in to discourage takeovers that appear to be nonproductive. Most such critics would have the government intervene only in cases where they see harm—for example, hostile takeovers and the use of high yield securities are two favorite targets. It is not possible to say, however, that all, or even most, transactions of a particular type are harmful, especially since the mere possibility of a

hostile takeover has a salutary competitive effect of unknowable significance.

The key question, then, is whether the government or some governmentally appointed agent of the public interest can distinguish, in advance, between individual transactions that will be good and those that will be bad for the economy. Can the government determine whether a merger will work out in the efficient and profitable way that the parties are betting it will? We think it is clear that the government is incapable of making that judgment.

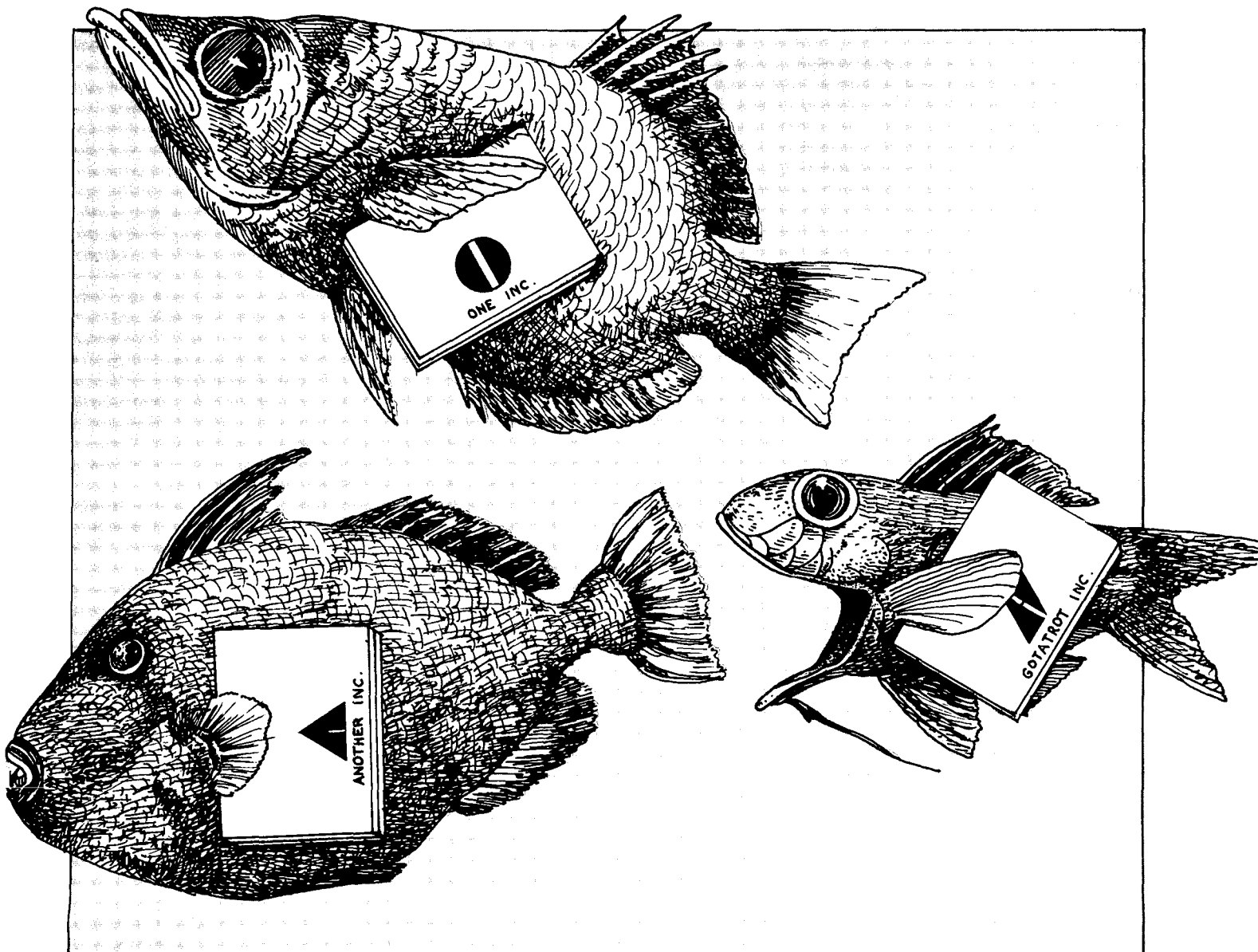
It is important to keep the nature of these transactions in mind. They are capital investment decisions, similar to other business decisions, such as new product development or new plant construction, except that the stakes are often larger. Sometimes the decision turns out very right, sometimes very wrong, and sometimes in between.

Government decision-makers, who do not have their own money at stake, are sure to be less accurate than the parties themselves in evaluating the business prospects of a merger. Government agents are also necessarily less familiar than the parties with the business and the particular

companies. Nor does the government have any better access to aggregate data or confidential information that would alter the parties' evaluation of the transaction if only they were aware of it.

If there is no decision rule that can be devised in advance and no public authority that can be set up to evaluate individual mergers correctly, the next question is whether mergers or hostile takeovers are, on average, good or bad for the economy. Unless it is clear that they are bad for the economy, we should not discourage them. Three types of empirical data shed some light on this question. No one of them is flawless, but some of the studies are far more rigorous and persuasive than others.

The primary data on the effects of these transactions come from "event studies," conducted by financial economists who track the behavior of stock prices before and after tender offers. The second type consists of accounting studies, which focus on the profitability of firms engaged in merger transactions. The third type of information is the anecdotal experience of critics of hostile takeovers, principally corporate managers.



*"Clearly the judgment
of the market is that, on average,
takeovers are likely to increase the
value of both companies."*

Evaluating the Data

Event Studies

The best information comes from the stock market's reaction to events during takeovers. The data are timely, forward-looking, comprehensive, and avoid problems associated with accounting conventions and taxes. The studies of stock prices reveal the consensus of all the participants in the market as to the expected value of the takeover proposal to shareholders of both the acquiring and acquired companies.

This evidence is unambiguous. In successful tender offer acquisitions, shareholders of the target company typically gain a premium of at least 30 percent over the pre-offer market price. That these shareholders always gain is to be expected, of course—otherwise they would have no reason to accept the tender offer. More significant, therefore, is that companies that make tender offers experience increases in their share values of about 3 percent.¹ Because these companies are usually larger than the companies they acquire, however, the actual gain on their investment in the takeover is closer to 9 percent (above their average return before the takeover). Clearly the judgment of the market is that, on average, takeovers are likely to increase the value of both companies.²

These event studies have been criticized by those who believe that the stock market is an unreliable indicator of value. Both sides of the debate generally agree that hostile takeover attempts occur because the target company's stock price is "undervalued." But they disagree sharply over why it is possible for an acquiring company to offer a significant premium and yet make a profit on the investment.

Until recently, this debate had reached what seemed to be an ideological impasse. Those who believe that the stock market is a reasonably unbiased (albeit imperfect) indicator of a company's prospects at any given time argue that a company is undervalued because either the existing management is not making the best use of the firm's assets or the

bidder brings new value-creating ideas or resources to bear on those assets.

Takeover critics, on the other hand, argue that the stock market systematically undervalues takeover targets because the market is increasingly dominated by institutional investors whose own performance is measured on a quarterly basis and who therefore base their analyses of corporate performance largely on short-term earnings. These critics argue that, notwithstanding the wealth increases resulting from takeover transactions, the market's alleged "short-term focus" is harmful to the economy's long-run productivity because it systematically undervalues corporations that engage in long-term planning and investments and thereby causes managers to underinvest in long-term projects. Therefore, these critics contend, stock price effects should not be used to determine the government's policy towards takeover and merger activity.

This "myopic market hypothesis" appears to be false based upon even a cursory observation of stock price behavior. First, if it were true, any new venture, especially one with no earnings history, would be unable to raise capital in the public equity markets. They do, of course, and the allegedly short-sighted institutional investors are among the principal purchasers of such offerings. Second, if the market were myopic, different companies in the same industry would not sell at different multiples of their current (or predicted near term) earnings. Unless the market is totally irrational, investors must believe that the long-term prospects of such companies differ significantly.

More important, however, three empirical studies that test the short-term hypothesis have recently been completed. First, the Office of the Chief Economist at the Securities and Exchange Commission (SEC) compared the amount of institutional ownership of, and research and development expenditures by, companies representing a cross-section of American industry with companies that were targets of tender offers between 1980 and 1983. The SEC staff discovered, contrary to the short-term hypothesis, that: (1) institutional investors not only do not shun corporations making above average research and development investments, they actually seem to prefer them; (2) takeover targets invested substantially *less* than the industry average in research and development during the years preceding the tender offer; (3) the percentage of institutional ownership of target companies was three-fifths of the percentage of institutional ownership of nontarget companies; and (4) the capital markets positively value companies that announce they are embarking on a research and development project. The staff concluded that its empirical findings appear to refute the short-term hypothesis.

Two other studies have been completed more recently by John Pound for the Investor Responsibility Research Center (IRRC). One study (using 1981–1984 data) tested the hypothesis that the increasing presence of institutional investors causes systematic undervaluation of takeover targets.³ It examined levels of institutional ownership, size of takeover premiums, and the success of management resistance. The findings are generally consistent with the SEC staff study in refuting the alleged adverse effects of institutional investors: (1) institutional ownership is lower for takeover targets than nontargets; (2) the level of the premium paid in takeovers is unrelated

to the extent of institutional ownership; and (3) the level of institutional ownership appears to have no bearing on the ability of managements successfully to resist unwanted takeovers.

The second Pound/IRRC study was designed to test the causes of the undervaluation in target companies' stock.⁴ Although this study uses accounting data (for the years 1978–1984), and is thus subject to the usual criticisms of such data, it reaches much the same conclusion as the SEC staff study: there is no evidence to support the hypothesis that takeover targets have “hidden” resources that are masked by short-term earnings reports, nor is there evidence that takeover targets invest more heavily in long-term activities and are, therefore, systematically undervalued by a stock market focused on the short run. In fact, this study, like the SEC study, finds evidence that takeover targets invest *less* in long-term activities than nontarget firms.

Some takeover critics have argued that companies maintaining conservative debt levels are especially vulnerable to hostile takeovers and that such takeovers should be curtailed because they often lead to “over-leveraged” companies. The second Pound/IRRC study also tested whether takeover targets are systematically undervalued because they have less debt on their balance sheets and are thus being penalized by the market for their more cautious management. Pound discovered, however, that there is no significant difference in leverage among the control group of corporations, those involved in friendly mergers, and those taken over in hostile transactions. Indeed, targets of hostile takeover attempts were slightly more leveraged than nontargets. Remarkably, however, those companies that had successfully resisted takeovers had substantially *greater* leverage — *before* the takeover attempt — than all three of the other groups.

These three recent studies refute the hypothesis that there is a systematic flaw in the stock market valuation of takeover targets. The myopic market hypothesis is not supported in fact any more than it is in economic theory. It offers no valid reason to conclude that the wealth created by takeovers is somehow contrary to our national interest.

Accounting Studies

The only other significant empirical research that attempts to determine whether mergers or takeovers are, in the aggregate, good or bad relies on analyses of accounting data. The work of Professor F. M. Scherer of Swarthmore College and David Ravenscraft of the Federal Trade Commission Bureau of Economics is among the most recent and interesting of these efforts. Using line-of-business accounting profitability data between 1974 and 1977, they have compared lines of business that experienced substantial merger activity between 1950 and 1977 with lines that did not experience such activity. They conclude that, although profitability may be slightly higher (for mergers between “equals” and those using “pooling of interests” accounting) or slightly lower (for mergers using “purchase” accounting) in lines of business that have sustained substantial merger activity, when the premium paid to effect the merger is counted, the net effect is negative.

Accounting studies, however, particularly those that attempt to measure profitability, suffer from serious meth-

odological problems that limit their relevance for policy purposes. For example, they do not take into account the real market values of acquired assets — only the accounting valuations, which may significantly understate their value. They generally encounter great difficulty in allocating beneficial externalities that the purchase may generate for the acquirer, such as a target's tax-loss carry-forward. Moreover, unlike the studies based on stock price data, accounting studies have not yielded consistent significant results. As a result, the interpretation and value of these studies is highly uncertain.

Anecdotal Evidence

The third category of evidence on the question whether mergers and takeovers are good or bad is the experiential and anecdotal information offered by some corporate managers and some of their investment bankers and lawyers. Notwithstanding their obvious self-interest, these people should at least be heard — they are on the industrial frontlines making the economy work, and they may know intuitively what investors, or even economists, have not yet discovered. In general, the managers object to being forced (in their view) to “waste” valuable management time and resources worrying about and defending against the possibility that someone may be able to take control of “their” business because an irrational, capricious, or short-sighted stock market has undervalued it. Institutional investors have been the prime villains, to hear these managers, although the recent empirical research by the SEC staff and Investor Responsibility Research Center should put an end to that particular bit of finger-pointing.

“The myopic market hypothesis is not supported in fact any more than it is in economic theory. It offers no valid reason to conclude that the wealth created by takeovers is somehow contrary to our national interest.”

Some of these merger critics express the concern that, because of stock market undervaluation, it is cheaper to buy capacity or products in the capital markets than to build or develop them in the real world—the “drilling for oil on Wall Street” lament. This phenomenon occurs primarily in industries that are undergoing significant changes due to external shocks — the oil industry (significant price declines), the telecommunications and transportation industries (deregulation), and the tobacco industry (declining demand). The decision to acquire existing oil reserves rather than engage in exploration, or otherwise to acquire real assets in the capital markets, are investment decisions, not fundamentally different from any other “make or buy” decision that businesses face every day. Nor are they any more sinister.

The ultimate object is to squeeze the most output from all available resources. Erecting barriers to takeovers on the premise that creating new assets is always “better” would be a grave error. No public interest is served when someone creates new assets at a greater cost than would be required to use existing assets. Indeed, even if the capital market’s undervaluation of existing assets were irrational (and the evidence indicates it is not), economic productivity is greatest when assets flow into the hands of those who value them most. This is the best assurance that they will be put to their most productive use.

Curbs on Defensive Tactics

The only area associated with corporate takeovers that is cause for some concern is the occasional use by target company managers of defensive tactics that are not in their own shareholders’ interest. The agency problem between shareholders and managers of widely held public corporations enables some managers to preserve their control, and thus their employment, at the expense of their principals. State corporation laws, which govern the relationship between shareholders and their hired managers, continue to evolve,

however, in order to deal with such problems as they arise. Moreover, shareholders can protect themselves through corporate charter amendments and the contractual arrangements they enter into with their managers. Indeed, state corporation laws have accommodated rapid innovation in the last several years in order to adapt to newly possible hostile takeovers.

While we may not agree with all of these state law developments — or every decision of the courts or of shareholder votes under them — we should be extremely reluctant to displace them with federal laws. We should prefer to solve these problems at a level closer to the problem and to the facts, preferably at the shareholder level. A federal statutory rule would be both overbroad (prohibiting activities it should allow) and underinclusive (missing some abuses, as they will continue to evolve). Unless there is convincing evidence of a serious problem of national dimension, the diversity of state law is preferable to a single federal law because it provides a laboratory for a variety of approaches and minimizes the cost of error. We have seen no such evidence of a serious problem, however.

There is also evidence that the courts are devising a more probing approach than in the past, when their unquestioning deference to managements under the “business judgment rule” appeared to give managers completely free rein to defeat unwanted tender offers. It would be entirely premature to conclude at this point that there has been a breakdown that warrants federal intervention into corporation law.

Conclusion

From the available evidence, we conclude that the market for corporate control works well. There is no market failure that should cause the government to intervene. Both economic theory and the great weight of the available evidence clearly point to a net benefit to the economy from takeover activity. While there certainly are mergers and takeovers that individually may reduce wealth rather than create it, the government is less capable of distinguishing between these two types of cases than are the private parties, who have better information and a substantial financial incentive to be right in making these judgments.

*“The ultimate object
is to squeeze the most output
from all available resources.
Erecting barriers to takeovers
on the premise that creating new
assets is always ‘better’ would
be a grave error.”*

1. Michael C. Jensen and Richard S. Ruback, “The Market for Corporate Control: The Scientific Evidence,” *Journal of Financial Economics*, vol. 11, no. 1 (1983).

2. It is worth noting that, in making this judgment, the market takes into account the transaction costs to both sides — lawyers, investment bankers, management distraction, etc. All of the costs are borne by the parties, and there are few negative externalities, so the market’s private judgment is based on the same considerations as a more global social welfare judgment and is a good proxy for the “public interest” as it is affected by the takeover. The two factors that the market may not consider are: (1) the interests of adversely affected employees, including, most often, incumbent managers in hostile deals; and (2) tax consequences that the Treasury will absorb.

3. John Pound, *The Effects of Institutional Investors On Takeover Activity: A Quantitative Analysis* (Investor Responsibility Research Center, November 1985).

4. John Pound, *Are Takeover Targets Undervalued? An Empirical Examination of the Financial Characteristics of Target Companies* (Investor Responsibility Research Center, January 1986).

Takeovers: Present and Future Dangers

F. M. Scherer

FOR THE FOURTH TIME this century, America is experiencing an intense wave of merger activity. A distinguishing characteristic of the current wave is the high incidence of tender offer takeovers — acquisitions in which the acquiring company bypasses the target corporation's management and seeks to buy a controlling interest directly from the target's stockholders. Here we address two main questions about the takeover wave of the 1980s: why is it happening, and what are its implications for the vitality of the U.S. economy?

Takeover Motives

Takeovers, like mergers in general, often are initiated for a variety of complex reasons. It is scarcely an exaggeration to say that there are twice as many theories of merger plus one as there are scholars studying the phenomenon.

One of the most pervasive motivating forces in the late 1970s and early 1980s was the depression of common stock prices relative to the real costs of plant, equipment, natural resources, and reputational replacement. Until recently it was often cheaper to buy a going concern on the stock market than to build it the hard way — from the ground (or underground) up. For those who anticipated an early end to Federal Reserve Board policies that drove interest rates to extraordinarily high levels, acquisitions were an excellent speculative play. High interest rates made income-producing assets cheap, but if an acquirer could wait out the temporarily high carrying cost, he could refinance his purchase at lower interest rates and realize handsome capital appreciation.

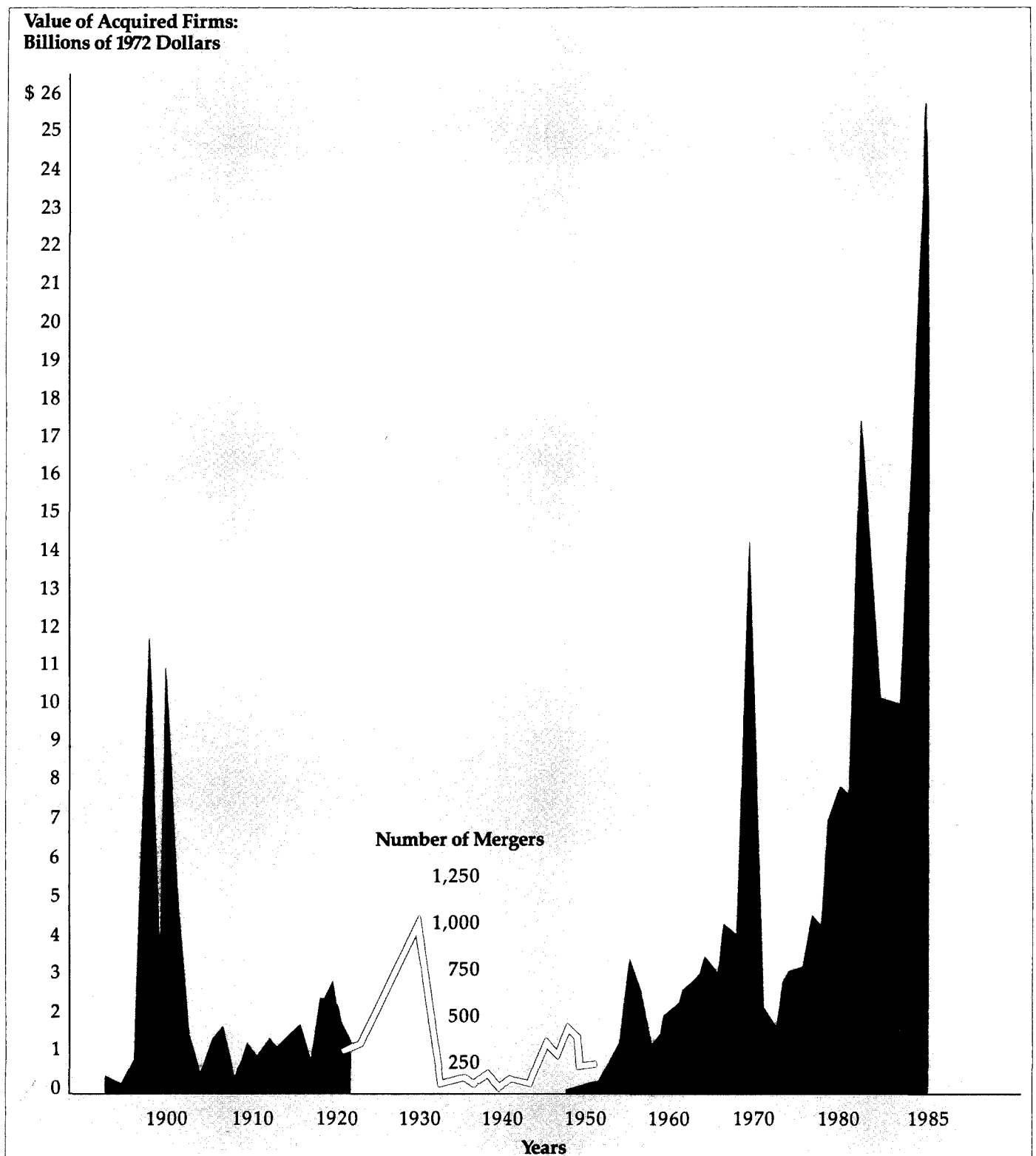
This theory of takeover motivations implies that the market has erred in valuing corporate assets, either generally or in specific company situations, and that those who see through the mistake can profit from a combination of perspicacity and boldness. An alternate theory argues that it is incumbent management, not the market, that has erred, and that by seizing control of a company and displacing its managers or reorienting their policies, a tenderer can increase the company's market value. Henry G. Manne stated this proposition in a seminal article published two decades ago: "Only the takeover scheme provides some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interests of . . . non-controlling shareholders."¹

Stock Market Evidence

Recently a stream of research has emerged from two of Manne's earlier homes, the Universities of Chicago and Rochester, which purports to document his theory by showing that mergers and takeovers, on average, increase efficiency for the economy as a whole.² The logic is simple. The consequences of merger are as-

F. M. Scherer is a visiting fellow in the Economic Studies program at Brookings, on sabbatical from Swarthmore College. With David Ravenscraft of the Federal Trade Commission, he is co-author of the forthcoming Mergers, Sell-Offs, and Economic Efficiency.

Figure 1.
Constant-Dollar Volume of Manufacturing
and Mineral Company Acquisitions, 1895–1984



Note: Data on the value of manufacturing and mineral company acquisitions are not available for the years 1921–1947. The white line reflects the number of acquisitions in those years.

Sources: F. M. Scherer, *Industrial Market Structure and Economic Performance* (revised edition, Houghton-Mifflin, 1980), p. 120; extended using Federal Trade Commission and W.T. Grimm Co. data.

sessed by studying how stock market investors anticipated those consequences at the time of merger “events” — that is, in the four weeks before and after a takeover announcement. The typical “event study” shows that the share prices of the target firm rose sharply as word of an impending takeover, and the stock price premium it will bring, spreads. On the target side, “value” is clearly enhanced.

What happens on the acquiring company’s side is less settled. Most studies reveal no significant short-run change in the value of the acquirer’s shares, although a minority show modest percentage gains. This evidence — positive stock value gains for target company shareholders and zero or slightly positive gains for acquiring company shareholders — is interpreted as showing that takeovers are expected to enhance the value of the combined enterprises, presumably by increasing their joint efficiency or the success with which they pursue the profit maximization goal. And if the efficiency of the merged enterprise rises, the efficiency of the economy as a whole must improve too.

Among the various objections raised to these studies and their interpretation, two stand out. First, the typical focus is on stock market reactions during a very short time frame surrounding takeover announcements. When the post-takeover interval is extended to two or more years, there is considerable evidence that stock prices of the acquiring company *decline* relative to the levels that would have been expected had the shares simply mirrored the performance of non-merging companies in comparable risk classes. The statistical tests used to analyze stock price changes over longer intervals are weak, however, so high confidence cannot be placed in this result. Still the apparent decline is an important anomaly in the conventional event study interpretation, for if shares of the acquiring company lose value relative to the overall market, it can no longer be argued that aggregate economic value has been augmented.

Second, even if there is a gain in the share value of the merged company, the increase does not necessarily prove that expected real operating efficiency increases are responsible. Tax savings resulting from merger might benefit the corporations involved but increase the federal Treasury’s red ink commensurately. Or the takeover announcement may act as a signaling device, spurring investors to revise their estimates of the merged firms’ value without changing their expectations concerning underlying earning power. Such revaluations, which imply that the market erred previously, are ruled out axiomatically by stock market event analysts on the assumption that markets are “efficient,” constantly factoring in all attainable information affecting security values. However, although the question is singularly resistant to conclusive resolution, the existence of such “signaling” effects cannot be dismissed out of hand.

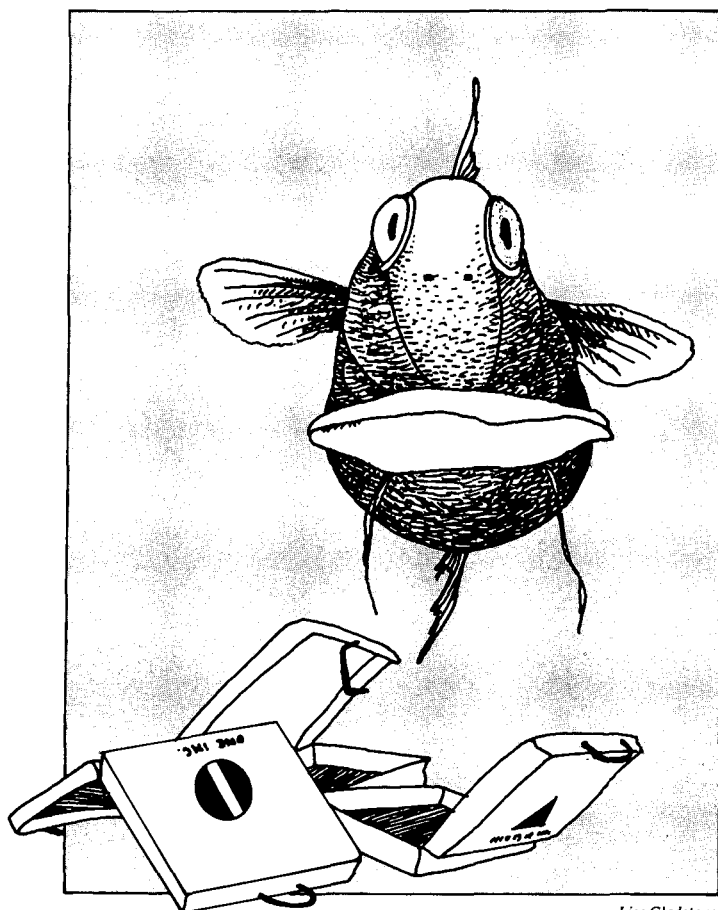
Profitability Studies

To escape the ambiguity of stock market event studies, we must seek other kinds of evidence on the characteristics of takeover targets and what actually happens after acquisition. Evidence on pre- and post-takeover operating profitability can illuminate two important hypotheses. First, if takeovers occur because managers have been inefficient, or less than diligent in maximizing profits, target companies should exhibit lower pre-takeover profitability than non-

target peer enterprises. Second, if operating efficiencies result from takeover, post-takeover profitability should rise relative to pre-takeover profitability, other factors (such as general business conditions affecting the relevant industry) held equal.

With co-investigator David Ravenscraft, I have tested these hypotheses using unusually rich data derived from the Federal Trade Commission’s line-of-business financial reporting program.³ The 456 to 471 U.S. manufacturing corporations included in the FTC’s samples for the years 1974 through 1977 accounted for 75 percent by asset value of all sizable manufacturing and minerals sector acquisitions over the period 1950–1976. Among those mergers were 82 tender offer acquisitions of manufacturing enterprises, including 21 cases in which the tender offer went through despite incumbent management opposition and 13 cases in which the acquirer was a “white knight” favored by the target company’s management over a “hostile raider.” The

“... even if there is a gain in the share value of the merged company, the increase does not necessarily prove that expected real operating efficiency increases are responsible.”



Lise Gladstone

median year of tendering was 1968, which puts our analysis in the realm of economic history and outside the time frame of the ongoing merger wave. There is virtue in this necessity, for only with an appropriate time perspective can the full effects of takeover be assessed.

For 77 of the 82 tender offer targets, we obtained operating income/assets ratios for the two years preceding (or overlapping) the precipitating tender offer announcement. After appropriate adjustment for changes in profitability associated with the business cycle and inflation, the simple average two-year pre-takeover operating income/assets percentage for the target companies was 12.04 percent. This average is below the comparable 12.50 percent figure for all manufacturing corporations, but the difference is small and (with a standard error of 0.67 percent) statistically insignificant. Thus, the tender offer targets of the 1960s and 1970s did not underperform appreciably, if at all, relative to their manufacturing sector peers.

Similar pre-takeover profitability analyses have been reported for the late 1970s and early 1980s. Both the Investor Responsibility Research Center (IRRC)⁴ and Edward S. Herman and Louis Lowenstein⁵ found that the targets had healthy average pre-offer returns on stockholders' equity. Only IRRC reported a test of statistical significance, which showed no noteworthy difference from "control group" values. All of this evidence appears to be inconsistent with a general "lax management" theory of tender offer target selection, although as in all statistical work, individual cases may support the theory.

To determine how well tenderers managed the assets

they acquired, Ravenscraft and I used line-of-business data. The compelling advantage of these data is that, instead of being buried within the diverse range of activities conducted by the parent enterprise, the acquired assets can be examined at the level of units operating in a narrowly delineated industry category such as cookies and crackers, anti-friction bearings, or photographic equipment. On average, companies covered by the line-of-business sample broke their operations down into eight non-miscellaneous manufacturing lines, with a range of from one to 53 lines.

For each of the 2,732 manufacturing lines on which data for the three years 1975-77 were available, the operating income/assets percentage was related to the average of the single industry category to which it belonged. Thus, a line with a three-year average operating income/assets ratio of 13.7 percent was viewed as an underperformer if its industry category was pharmaceuticals (with an average return of 18.1 percent) but an overperformer if its home base was glass containers (with an average of 10.8 percent). We also took into account the extent to which profitability varied systematically because of the line's market share and the method of accounting (purchase or pooling-of-interests) used to bring the merged assets onto the acquiring corporation's books.

The key question is whether, controlling for these other profit-influencing variables, manufacturing lines acquired through tender offer takeovers or their white knight alternatives had below- or above-average profitability. On average, we found that the operating income/assets ratio for 119 tender offer acquisition lines was 2.95 percentage points lower than that of otherwise comparable lines — a 22 percent deficiency compared with the average return of 13.34 percent for the whole sample.

Profitability deficiencies of approximately equal size were found for each of three distinguishable tender offer classes—hostile takeovers, white knight acquisitions, and those made without overt management opposition. Further analysis reveals that most of the observed post-takeover performance deficiency was associated with the higher asset values and depreciation charges that result from the payment of substantial premiums over pre-merger book value to effectuate the takeover. Once those revaluation effects are factored out, there is no evidence that the acquiring companies managed their acquired assets either clearly worse or clearly better than the average of the industries to which the acquired lines belonged.

This finding of "no significant change" is at odds with the hypothesis that takeovers increase efficiency and pre-tax profits. If the takeover premium was paid in the expectation of increased profitability, tenderers must have systematically overestimated their ability to manage the target firm's operations better than the prior incumbents.

Special Circumstances of 1980s Takeovers

These findings pertain to takeovers of the 1960s and early 1970s. For takeovers of the 1980s, we shall have to wait until the 1990s to perform a comparable analysis, if the needed data are available at all; the Federal Trade Commission has not collected line-of-business data since 1977.

However, it is already apparent that the takeovers of the early 1980s are clearly different in at least one fundamental

respect. They occurred in an environment of unusually high nominal and real interest rates. High interest rates, we have seen, reduce income-earning asset values, often below current replacement costs. An increase in real interest rates also affects calculations of the discounted present value of projected future earnings. The higher the interest rate, the smaller will be the discounted present value of a given earnings stream. The more that earnings stream is extended over time, the more its discounted present value drops in response to a given real interest rate increase. Such reductions in value help explain why reserve-rich petroleum companies were such attractive takeover targets, for few industries have assets that yield cash flows over such long periods.

There is also a broader implication. In the oil company takeover battles of the past three years, an important point of contention has been the amount of investment that should be devoted to risky, far-sighted exploration programs. Finding and developing new reserves to the point where commercial quantities of oil or gas can be extracted and transported to market takes from five to ten years. Once commercial production is under way, cash flows will continue for decades thereafter. How such future prospects are valued in today's terms depends upon the discount rate applied, which, in turn, is based upon the evaluators' interest rate expectations, as well as on short- and long-term oil price expectations.

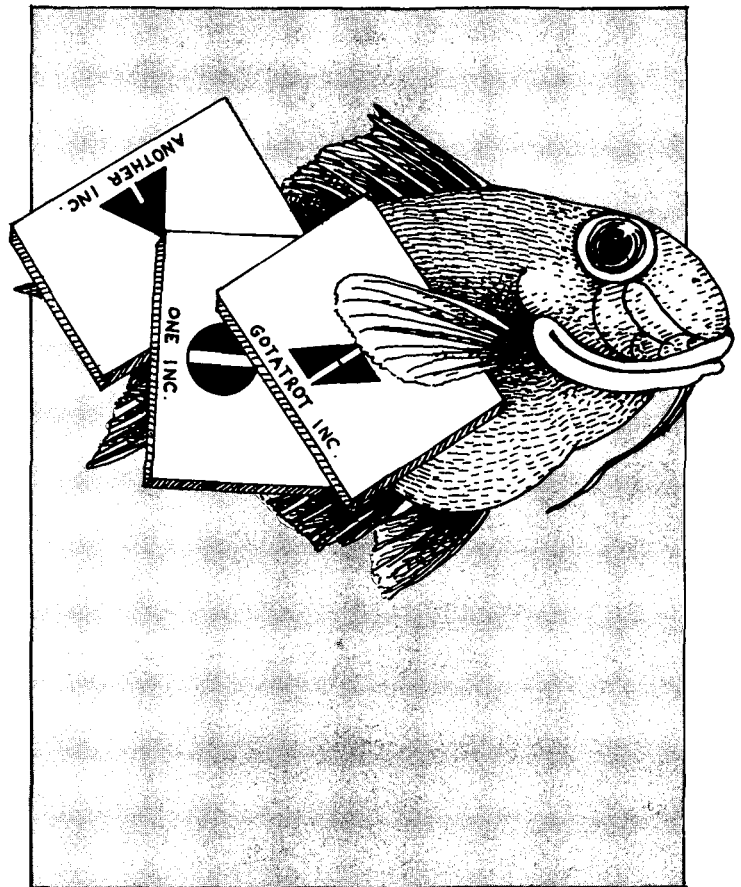
I believe many oil company executives viewed the high interest rates of the early 1980s as a temporary aberration, to be "smoothed" downward in making exploration decisions whose fruits would not appear until the 1990s (when supplies are expected again to be tight) and continue into the twenty-first century. The stock market, on the other hand, has almost surely been applying a relatively high discount rate to such investments.

The disparity between these two assessments sows the seeds for a takeover conflict. Outsiders who seize control and alter oil company investment policies to conform more closely with current stock market preferences can indeed create enough market value to justify the payment of a takeover premium. The critical question is whether the added stock market value resulting from more short-sighted investment policies also benefits society at large? Or is it a gain we may regret having realized as the interest rate structure and the oil supply-demand balance change in future years?

Those who advocate overriding the judgment of competitive markets, however short-sighted those markets may be, ought to have compelling grounds. I can advance two general rationales plus two others more or less unique to the energy company takeover debate that corporate managers and/or policy-makers might consider.

Ensuring Future Energy Supplies

Beginning with the specifics, there is much to be said for smoothing the transition to an environment in which oil and gas resources are permanently scarce. The oil shocks of 1973–74 and 1979–80 caused massive dislocations in the world economy, throwing millions of persons out of work and depressing productivity growth rates in most industrialized nations. The more recent correction—a sharp decline of oil prices—is likely to stimulate consumption and



Lise Gladstone

discourage exploration, setting the stage for still another shock. Smoothing the flow of newly discovered reserves can help reduce the macroeconomic trauma.

Second, when future energy supply and demand balances are so difficult to predict, it is good policy to "let a thousand flowers bloom"—let the pessimists seek new oil now and the optimists wait until the crisis they hope will be averted draws nearer.⁶ However, when an active takeover market permits the non-drillers to impose their short-sighted preferences on all or most energy companies, that valuable diversity by which we smooth the transition to new resource market regimes is lost.

Maintaining Competitive Industries

More broadly, income taxes (and especially the double taxation of common stock dividends) cause the discount rates used by private decision-makers to be lower than the rates someone acting for society as a whole would apply. Similar divergences are caused by risks that are diversifiable for the economy as a whole, but not for individual corporate investors. For these reasons it has often been argued that the discount rates applied by private sector investment decision-makers are too high.⁷ To be sure, the problem has deep macroeconomic roots, and not much can be done by individual decision-makers to correct it. But at the least, its existence suggests that one ought not discourage the downward smoothing of discount rates when costs of capital are unusually and nonsustainably high, as they were during the early 1980s.

Finally, it is difficult for managers to execute long-range business strategies in a stop-and-go environment — one in which discount rates swing widely from quarter to quarter. Under such circumstances, management's failure to re-adjust investment strategies to fluctuating financial market exigencies could lead to a takeover attempt. As Harvard Business School professors Gordon Donaldson and Jay W. Lorsch observed in their study of top management decision-making: "[M]anagers' experience has taught them that investors' judgments and expectations are often out of phase with their own judgments, expectations, and needs. Just when the company's vital financial and competitive interests are at stake, the market's terms may be wholly unacceptable. . . . The corporate managers in this study . . . saw the pressure for near-term performance as incompatible with the natural cycles of investment and return on investment, particularly in capital-intensive industries."⁸

Although the proposition is not easily proved, I am convinced that genuine industrial strength is much more likely to be built in an environment that encourages smoothing market discount rates and taking the long view than from readjusting strategies with each short-run turn of the capital markets. This view has obvious application for investments in plant, equipment, research, and natural and human resource development. Less well-recognized but equally important is its application to pricing strategy. The company with a substantial market position and/or well-accepted products often faces a strategy choice. It can adopt a "harvest" strategy — setting its prices high and taking quick profits but risking loss of the market. Or it can take more modest current profits and, by building or at least maintaining its market share, sustain future profits. High discount rates favor the harvest strategy, lower rates a market position building strategy.

"The society-wide benefits of takeovers have almost surely been exaggerated by their advocates; the risks are real, though poorly measured. The debate needs to be refocused on the fundamental question of what makes for good industrial performance."

The broader public interest may not have been affected much by such choices in the past, for if Peter chooses to let his market share decline, Paul's will grow. But in recent years, the Peters have been domestic producers and the Pauls importers. Time and again, domestic industry leaders have applied high discount rates to the future with predictable consequences. They set prices high, then watched their market positions give way to more aggressive foreign rivals. Eventually they experienced a loss of competitive strength. To the extent that such behavior is encouraged by takeover threats motivated in turn by the financial markets' preference for short-term gains, the nation is almost surely worse off as a consequence. How much of our future market strength we have squandered because of takeover threats and their consummation is something about which too little reliable evidence exists.

Conclusion

At the very least, my research with Ravenscraft suggests the need for a cautious, skeptical policy toward tender offer takeovers. The conventional wisdom that tender offer targets are characteristically poor performers does not appear to be true on any broad scale. Historical evidence suggests that tenderers have not managed the businesses they acquired any more profitably than their industry peers, nor have they achieved significant profitability improvements relative to the pre-takeover situation. In an environment of high interest and discount rates (which, one hopes, is now largely behind us), there is a danger that managers' investment decisions will be skewed by takeover threats in ways that undermine long-term industrial strength. The society-wide benefits of takeovers have almost surely been exaggerated by their advocates; the risks are real, though poorly measured. The debate needs to be refocused on the fundamental question of what makes for good industrial performance. Given such a reorientation, there is a critical need for more solid evidence and less recitation of unsubstantiated "efficient markets" theology.

1. Henry G. Manne, "Mergers and the Market for Corporate Control," *Journal of Political Economy*, vol. 73, no. 2 (April 1965), p. 113.

2. For surveys, see Michael C. Jensen and Richard S. Ruback, "The Market for Corporate Control: The Scientific Evidence," *Journal of Financial Economics*, vol. 11, no. 1 (1983), pp. 5–50; and Paul Halpern, "Corporate Acquisitions: A Theory of Special Cases?" *Journal of Finance*, vol. 38, no. 2 (May 1983), pp. 297–317.

3. David J. Ravenscraft and F. M. Scherer, "Life After Takeover," and "The Profitability of Merger," working papers, 1986.

4. John Pound, *Are Takeover Targets Undervalued? An Empirical Examination of the Financial Characteristics of Target Companies* (Investor Responsibility Research Center, January 1986).

5. Edward S. Herman and Louis Lowenstein, "The Efficiency Effects of Hostile Takeovers: An Empirical Study," paper presented at a Columbia University Law School conference on Takeovers and Contests for Corporate Control, November 1985.

6. See Burton H. Klein, *Dynamic Economics* (Harvard University Press, 1977), especially Chapters 3 and 6.

7. See Edward Gramlich, *Benefit-Cost Analysis of Government Programs* (Prentice-Hall, 1981), pp. 95–108; and Edgar K. Browning and Jacqueline Browning, *Public Finance and the Price System* (Macmillan, 1979), pp. 89–93.

8. Gordon Donaldson and Jay W. Lorsch, *Decision Making at the Top* (Basic Books, 1983), pp. 51–52 and 170.

"Commissionitis" in Higher Education

Paul E. Peterson

NATIONAL COMMISSIONS have a number of virtues. They highlight central issues, provide an opportunity for the application of disinterested expertise, and state overall solutions to matters of broad public concern. But they do not have unbounded capacities for overcoming the fragmentation that seems endemic to American public policy-making. Too often commission recommendations lack substance. More important, commissions themselves lack authority. Deprived of the power to implement their recommendations, they are free of responsibility. Devoid of both power and responsibility, they often behave like temperamental children, exaggerating the problem to get attention, espousing ideals more romantic and noble than modern-day conditions can accommodate, and proposing far-reaching remedies that take no account of limits on resources.

These tendencies were particularly evident in the recent reports of the commissions on elementary and secondary education. Those commissions used statistics selectively in ways that grossly exaggerated problems in American education; they espoused goals so vague and general as to be indisputable; and they made recommendations that were either wholesome dishes for which no recipe was supplied (e.g., students should do more homework), gourmet dishes whose costs exceeded available resources (teachers' salaries should be increased by 25 percent), or desserts of puff and air that melted as soon as you bit into them.

The four commission reports on higher education are not subject to quite the same criticisms. Written with more elegance and style, they are more cautious in their identification of the problems, more focused in their statements of objectives, and more direct and concrete in their lists of recommendations. If colleges and universities would implement the proposals these commissions on higher education agree upon, they would make changes of profound significance. The recommendations may be less than wholesome main dishes, but they are certainly not puff and air.

The clarity of the reports stems in part from the *unrepresentative* nature of these commissions. In contrast to the potpourri of superintendents, school board members, teachers, university academics, and government officials who sat on the school commissions, the university commissions each had a cohesive membership with a particular story to tell and a single case to make. In two instances, one person wrote the report and took personal responsibility for its contents. In some ways, the value of these reports lies in the fact that they were not really prepared by *national* commissions at all.

The reports vary considerably in style and substance. To emphasize their differences I have given each of them a label that highlights its particular thrust. The *classical* report was prepared under the auspices of the National Endowment for the Humanities; the *liberal arts* report was produced by the Association of Amer-

Paul E. Peterson is director of the Governmental Studies program at Brookings. He is editor of *The New Urban Reality*, co-editor of *The New Direction in American Politics*, and author of *The Politics of School Reform, 1870-1940*. An earlier version of this paper was prepared for the National Invitational Conference on Transition Points in Higher Education held at Temple University. The author's critique of commission reports on elementary and secondary education appeared in the winter 1983 issue of *The Brookings Review*.

*"If colleges and universities
would implement the proposals
these commissions on higher
education agree upon,
they would make changes
of profound significance.
The recommendations may
be less than wholesome
main dishes, but
they are certainly not
puff and air."*

ican Colleges; the *progressive* report was written by a study group formed by the Department of Education; and the *liberal reform* report was sponsored by the Carnegie Foundation for the Advancement of Teaching.

Points of Divergence

The classical report is the work of William Bennett, then the head of the National Endowment and today the secretary of education. Although Bennett consulted a group of scholars and university officials who share his concern for the quality of college instruction in the humanities, the study reflects his personal commitment to the great books tradition in which students are exposed directly to the writings of classic works in philosophy and literature. The report laments the decline of foreign language instruction and the dwindling number of humanities majors, claiming that "the most able undergraduates" are shunning the humanities in favor primarily of professional and technical fields. "This is not merely a rejection of a career in the humanities," the report declares, "but a rejection of the humanities themselves." Bennett says that, instead of providing a "bus trip to the West," the college curriculum should combine broad reading with close reading of "original literary, historical, and philosophical texts rather than secondary works."

The liberal arts report, sponsored by the Association of American Colleges, expresses the concerns of the arts and humanities faculties at small private colleges. The members of the committee tended to come from small colleges or the college faculty at private universities, and, in particular, from the humanist faculty at these colleges. Research-minded professors, administrators of the multi-university, and representatives of land-grant colleges were largely excluded from the committee. According to this report, the central problems have been created by the preeminent power of the academic disciplines and the university departments that house them as well as by student demands shaped by the requirements of professions and occupational licensing entities external to the university. These institutional forces have so penetrated the college curriculum that it has become a hodge-podge of student electives; vaguely stated and loosely connected general requirements; and narrowly defined, occupationally-related specialty courses. Instead of rejoicing in the diversity of American higher education, the committee deplores the fact that "the nature and degree of . . . concentration [in a student's major] varies widely and irrationally from college to college."

The committee also objects to a reward system that has made "research a more important factor than teaching or even service on the curriculum committee." The solution they propose is to take from students their "new and commanding authority over the course of study" and lodge it in the hands of a curriculum committee that would resist departmental demands for specialized courses based on narrow faculty research interests as well as student demands for electives oriented toward their immediate career aspirations. The committee further recommends leaves for faculty members to undertake projects designed to improve teaching; creation of well-paid teaching professorships that transcend departmental affiliations; and appointment of qualified professionals, artists, and business leaders as part-time teachers. Finally, the committee sets forth a

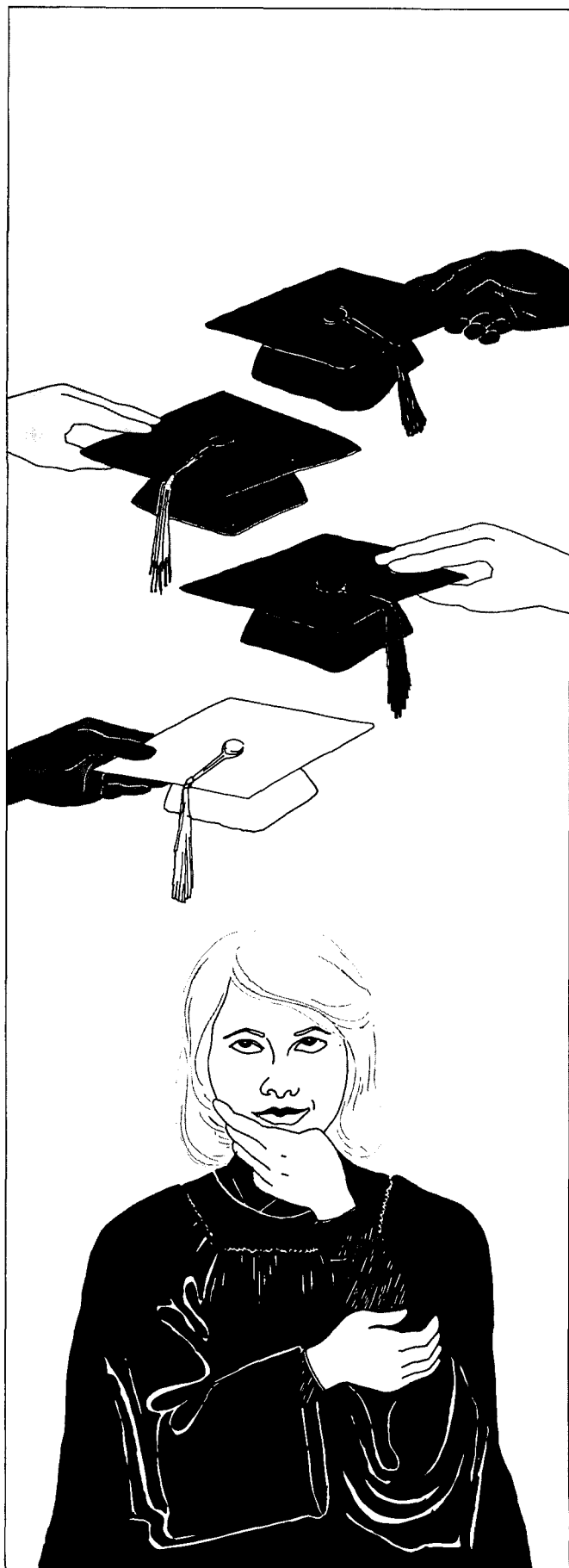
standard curriculum to which college catalogues should conform: it would teach inquiry, literacy, numeracy, historical consciousness, science, values, art, international and multicultural experiences, and study in depth in some particular area.

The third report is best labeled progressive, for it shares the faith in active student involvement in education and strong administrative leadership found in the writings of John Dewey and championed by the progressive movement in the early decades of this century. Written by a study group appointed by the director of the National Institute of Education, the report focuses on the processes by which learning occurs rather than its substantive content. Unlike the first two reports, it respects curricular pluralism and the diversity among higher education institutions. It has no objection to the university's role as a training institution for commerce, industry, and the professions. What concerns these scholars is not the direction of higher education but the efficiency with which it is moving.

The progressive's enthusiasm for active learning is manifestly evident throughout the report. Its very title, *Involvement in Learning*, is reminiscent of the child-centered language of the progressive era. The report calls for greater use of small discussion groups, internships, independent study, student involvement in research projects, and the like. Its more subtle message is that administrators should be endowed with greater authority over faculty decisions. Unlike the liberal arts report, this one does not find a need for a faculty curriculum committee to preserve curricular purity from the pressures of student demand and external licensing agencies. Instead, the guardians of the university should be administrators who are empowered to announce publicly the standards and expectations for students, measure carefully student progress, hold the faculty accountable for student outcomes, grant promotion and tenure according to a broader but cleaner definition of scholarship, and shift resources downward from the research and graduate-level components of the university to the first two years of college instruction.

The liberal reform report was written by Frank Neuman, former president of the University of Rhode Island and now head of the Education Commission of the States, and was issued by the Carnegie Foundation for the Advancement of Teaching. It is easily the most impressive of the four. Its assessment of higher education is more balanced: it places the university in a broader social, economic, and political context; and its argument is rooted in a goodly amount of intrinsically interesting information on current and prospective trends bearing on higher education. For example, it demonstrates that, although overall student aid has remained fairly constant, the amount of aid granted through scholarships rather than loans has steadily declined. The report also makes sane comments on a number of volatile topics. Disputing claims by some critics that America is losing its competitive edge, Neuman shows, for example, that America's leadership in research remains preeminent and that universities are responding quickly to the need for more engineers and computer scientists.

In contrast with the other studies, this report emphasizes the extraordinary achievements of the postwar American university. Neuman believes that the growth in higher education has stimulated technological advances,



trained an increasingly skilled work force, and opened up new opportunities for disadvantaged minorities. In his view, the United States has built the finest higher education system in the world, which, in turn, has prepared America for its leadership role in world affairs.

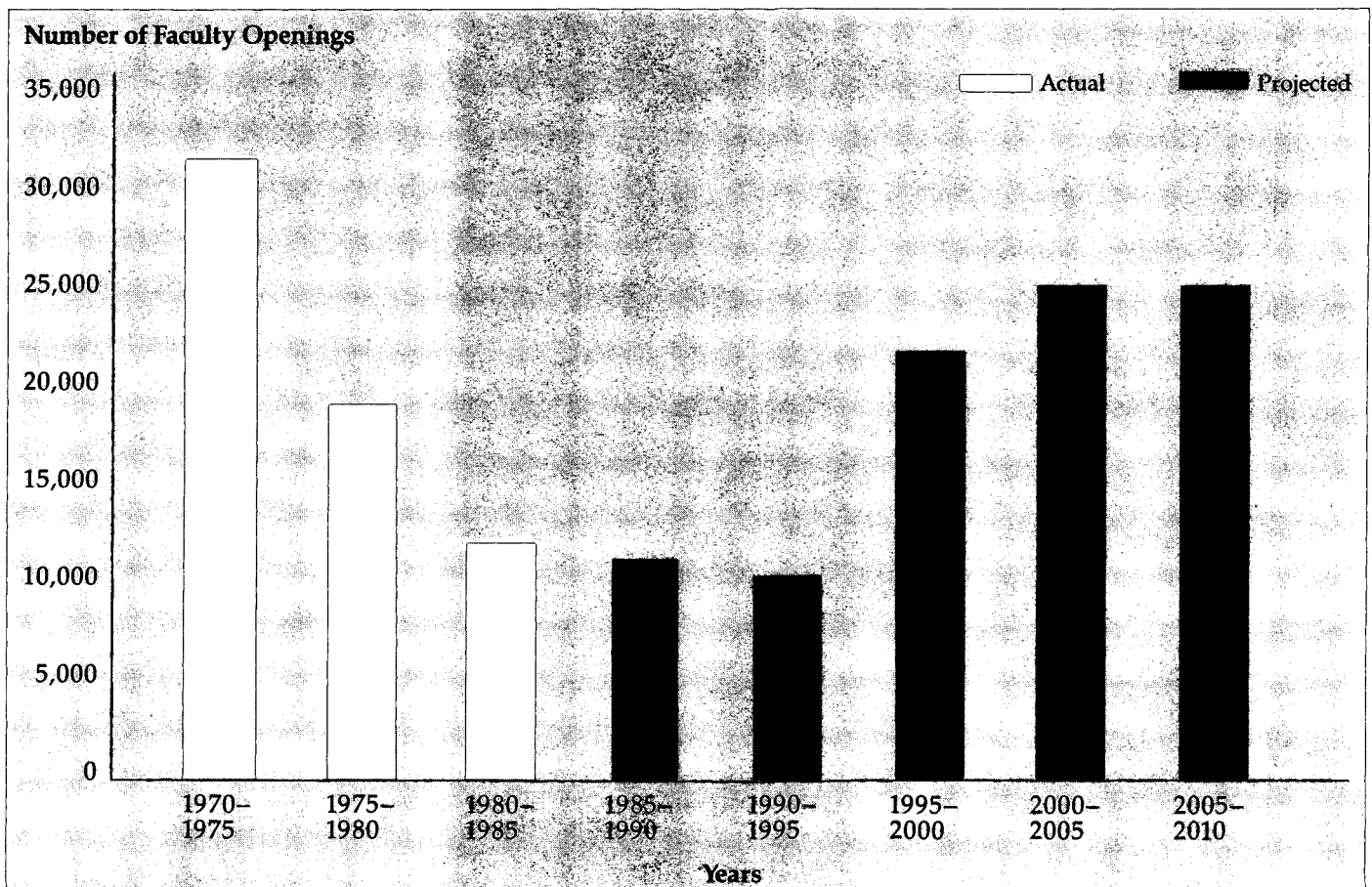
Neuman saves his distress for recent trends in higher education. He is concerned about the decline in federal student aid, the shift in aid from grants to loans, the stagnation in the percentage of minorities enrolled in colleges, the retrenchment in programs promoting international exchange and understanding, the shift in research to defense-related technologies, the decline in student civic activism, and the re-emergence of a student body more interested in employment opportunities than broad policy questions. Higher education once was the liberalizing, reforming element in society; it no longer is — or at the very least, current trends seem to be stifling that impulse.

Neuman's key solution is best captured by the catchy aphorism that he coined: Students used to work to learn; now they learn to work. As a result, the civic activist of yesteryear has turned into the self-seeking yuppie of the

eighties. To reverse the trend, Neuman calls for federally-funded work-study instead of loans; for public service work in return for financial aid; for need-based, service-based grants instead of merit scholarships; for classroom experiences that encourage creativity, risk-taking, and civic involvement; and for more federal support for non-defense related research.

As do many other liberal reformers, Neuman believes that education can redress many social ills. The reformed university will keep America competitive, restore civic consciousness to political life, promote international understanding, and incorporate minorities into the social mainstream. Until very recently, Neuman implies, the American university was well on the way to achieving these objectives. But a wave of cynicism following the Vietnam War, reinforced by a conservative mood in Washington, has frustrated much of what had once seemed possible. It is not American universities that need to be changed; it is only those reactionary innovations in federal policy that must be reversed.

Figure 1.
Demand for College Teachers
Annual Demand Averaged for Five-year Intervals, 1970–2010



Source: Office of Technology Assessment, Demographic Trends and the Scientific and Engineering Work Force: A Technical Memorandum (Washington, D.C.: U.S. Government Printing Office, December 1985).

These commission reports on higher education thus offer a range of ideas from which to choose. The classical and liberal arts reports urge a return to a core curriculum that gives as much weight to the arts and humanities as to science and mathematics. The progressive report urges publicly stated standards, careful measurement of student progress, and faculty accountability. The liberal reform report urges a return to higher levels of federal support for research and student assistance and to the establishment of work or service requirements in return for grants-in-aid.

Given these differences in orientation, one can find considerable disagreement on quite specific matters. The progressive report calls for comprehensive examinations in a student's major; the liberal arts report rejects them. The progressive report counsels against working outside the college campus; the liberal reform report favors jobs over loans. The progressive report extols student involvement and participation; the liberal arts report insists that tradition, acting through the curriculum committee, be given pride of place. The liberal reform study emphasizes the critical importance of university research and urges its extension into technological areas that could affect economic productivity; the liberal arts report insists that the significance of research is exaggerated at the expense of quality teaching.

Common Themes, Common Problems

For all their diversity, the reports have a number of common themes that resonate well among faculty members, students, and administrators. The studies generally reflect the broadly held view that colleges and universities have somehow misallocated their resources in ways that they find difficult to correct. Higher education gives too little recognition to the arts and humanities, which remain our society's best hope for sustaining high cultural standards in a world dominated by mass media hype. Too much specialization occurs too quickly in a world where constant technological change renders many specific skills occupationally obsolete. Too many student decisions are being driven by job-related calculations when an increasing amount of adult life is spent in leisure activities. Too little recognition and compensation is given to professors and scholars in a high-tech society more dependent on the university than ever before. Because the reports touch upon and reflect these social realities, they have appropriately stimulated widespread comment and discussion.

If the reports correctly identify some of the sources of the current discontent in higher education, they also suffer from commissionitis. They overlook achievements, romanticize the past, and consider only the benefits, not the costs, of the proposals they make.

With the exception of the Neuman report, the studies tend to downplay accomplishments and emphasize difficulties. To be sure, every report gives a nod to the great growth in American higher education, but only the Neuman report pays sustained attention to the components of this growth. As Neuman points out, American higher education embraces an extraordinarily diverse set of institutions: great state universities, small liberal arts colleges, prestigious private universities, commuter colleges, junior and community colleges, and vocational training programs. The variety in curricular offerings, social settings,

"Higher education gives too little recognition to the arts and humanities, which remain our society's best hope for sustaining high cultural standards in a world dominated by mass media hype."

entrance requirements, and extracurricular activities gives students a remarkable degree of choice. It is difficult to see how over 30 percent of the population could pursue a higher education had not this diversity developed. Indeed, those European countries whose centralized policies have precluded such diversity and growth are today handicapped by antiquated, overcrowded educational systems that cannot match student demand. Many reformers at the elementary and secondary level have identified standardization and lack of choice as major obstacles to quality education, yet these reports on higher education seldom celebrate the options Americans enjoy, and at least two of the reports would restrict them.

Admittedly, the variety of higher education institutions forces a competition among them. This competition could increase in the next decades as overall enrollments stabilize and the number of students in four-year degree programs begins to decline. Many in the academic community are concerned that the competition for students may enlarge recruitment budgets, exaggerate the importance of winning athletic teams, lower admissions standards, encourage permissive grading practices, and weaken the academic integrity of some institutions.

But competition does not necessarily lower standards; on the contrary, over the long run, it is likely to raise them in colleges and universities just as it improves the quality of personal computers and sports equipment. Those colleges and universities known for quality education still attract good students and strong faculties. Lowering educational standards may solve the immediate enrollment problem, but most college administrators know the long-term con-

sequences are likely to be exactly the opposite.

The Neuman report excepted, these critiques of higher education also either ignore or question the value of professional research. Yet it is the research arm of the university that is expected to produce the technological innovations that the nation depends upon for continued economic growth, a strong defense, and medical progress. In Snowbelt and Sunbelt, states and localities count on local universities to provide crucial support for technologically advanced industries along the lines occurring in California's Silicon Valley, along route 128 outside Boston, and in North Carolina's research triangle. Universities know that their prestige is ultimately based on the research triumphs they achieve, and, inevitably, they will give promising research the highest priority.

Quite apart from overlooking the extraordinary achievements of the higher education system, the reports call for a return to days of glory that either never existed or cannot be recovered, given the realities of modern mass education. The classical report bemoans the decline in the number and proportion of students majoring in the humanities, but it utterly ignores the fact that the humanities undergraduate faces considerably more limited job opportunities than does his computer-trained counterpart. At one time a university degree of any kind was virtual insurance against unemployment, rendering the choice of a college major less significant for one's future career. Today, it is romantic to argue that college graduates should not take into account the competitive and specialized labor market they will encounter upon graduation.

The liberal arts report decries the weakening of the core curriculum and the rise of specialization. But as Adam Smith once noted, it is the division of labor that enables nations to increase their productivity, and specialization in a world of an ever intensifying division of labor is a reality we must acknowledge. To expect 40 percent of the twenty-first century society to study the same core curriculum in the way 5 percent of the society did in the nineteenth century is utopian.

The progressive report wants more actively engaged students, and few can deny the benefits of the quasi-tutorial arrangements it proposes. But as many an overburdened faculty member can report, intensive and continuing commentary on the writing of a hundred or more students requires more time and energy than all but heroic teachers can provide. The liberal reform report calls for public service in exchange for university grants but does not calculate the fiscal and administrative costs, to say nothing of the value of the time commitment required of students.

Significance of the Reports

These shortcomings are not grounds for dismissing the reports altogether. Attempts by thoughtful Americans to comment on the direction of American higher education, the four studies constitute an effort at coherent, coordinated policy-making in a political system where that is seldom achieved. Their tendencies to paint a one-sided picture can be explained by the intense competition for political attention in which only an exaggerated, and thus misshapen, view is likely to gain a hearing. In fact, the reports call attention to a major problem that will remain on the higher education table throughout the rest of this century:

the need for faculty renewal in an era of enrollment decline.

As the accompanying figure illustrates, the demand for college teachers fell sharply during the 1970s and will fall still further over the next decade. This drop in demand will be particularly difficult for the university system to absorb because of the great numbers of faculty members who received tenure during higher education's great expansion in the sixties and seventies. Most of them are likely to remain in place until they reach the new retirement age of seventy, and, as a result, the demand for teachers is not expected to increase until the waning years of this century.

Prospects for graduate students, especially in the humanities and social sciences, are so discouraging that it is difficult to attract able young scholars into college teaching. Many are forced to begin their careers with part-time or temporary jobs. Even for those with full-time positions, the monetary rewards for teaching are much less than they were ten to fifteen years ago. It is understandable that faculty salaries failed to keep pace with inflation in the past decade; when labor supply exceeds demand, salaries necessarily fall. But a major challenge in the next decade is to prevent salaries from falling still further behind those in other professions so that able young people are not further discouraged from becoming college teachers.

A second major challenge will be to revise tenure policies. Tenure was devised to protect the scholar's academic freedom, but in practice it has also protected shoddy teaching, poor research, and avoidance of university and community responsibilities. Tenure also forces universities to retain older faculty members who have lost touch with current research at the expense of younger teachers and potential scholars.

Recognizing this problem, universities have begun to offer tenure more slowly, carefully, and selectively. The extraordinary growth in part-time personnel is one sign of an increasing reluctance to make long-term commitments. Between 1970 and 1982 full-time staff grew by 28 percent while part-time staff grew by 140 percent. Such strategies are probably necessary to maintain flexibility in a time of constrained resources. More sweeping revisions of tenure policies would require joint action by the higher education system as a whole. Were any one college or university to refuse to extend tenure privileges, it would become a pariah institution, ostracized by the American Association of University Professors and spurned by potential faculty members. Yet coordinated effort by all universities would be extremely difficult to achieve. The fact that not a single commission report even raises the issue demonstrates how sacrosanct tenure policies have become.

The reports, however, do appear to recognize the need to maintain teaching quality in a period of retrenchment. They offer a variety of suggestions short of tenure reform, including early retirement plans, cooperative arrangements with researchers and professionals outside the university, and higher levels of compensation than the market might require. One wishes the reports had focused on this problem of faculty renewal more directly. It would be unfortunate to let the quality of our higher education system decline in the next decade only to be forced to rebuild it in the following one when student enrollment will expand and the demand for college teachers will increase sharply once again. In the meantime, the system can be smaller and better, but only continued public support will make it so.

The Federalist No. LXXXVI

On Relations Between the Judiciary and Congress

Frank M. Coffin

Author's Note: Lest this essay be deemed a fraud and a hoax, let me assure the reader that it is not an actual communication recently received from Messrs. Madison, Jay, and Hamilton. It is, rather, what I am quite sure they would say if I but had a better ability to hear them.

Frank M. Coffin is a United States Circuit Judge, sitting on the Court of Appeals for the First Circuit. He is chairman of the Committee on the Judicial Branch of the Judicial Conference of the United States. He has also served as a member of Congress from Maine and as deputy administrator of the Agency for International Development.

ALMOST two hundred years ago, when the youngest of our trio was 30 and the oldest 42, we seized the opportunity to respond to doubters of the Constitution with a series of 85 essays called "The Federalist," which we wrote under the name of Publius. Although some historians claim that the luminous presences of our elders, Washington and Franklin, had more to do with ratification, we have always felt that the Federalist did its part.

Now by some eccentric dispensation, as the nation ends its second century, we are given the privilege of adding one more essay—only one. This of course makes us feel like Tantalus: when we stoop to drink, the water recedes, as does the fruit above when we reach for it. We have reached a decision not to recommend any change in the old charter. This was never our mission. And, remembering the tribulations the 55 of us had during four torrid months in Philadelphia when the country had fewer than four million inhabitants, we are loath to see the nation become Tantalus today.

Our focus therefore is not on changing the Constitution but on finding ways to improve its workings between the two branches of government that make and interpret the laws and possess the greatest continuity—or inertia—in the conduct of their business. The institution of the Presidency has been richly studied and written about. But the interrelation of Congress and the Judiciary remains as unexplored today as the western territories were in our time. We wrote in No. XLVII of the separation of the branches and in No. XLVIII of the connection that should exist among them. But neither Montesquieu nor the British or colonial experience gave us more than the foundation.

The lack of any superstructure has produced the following state of affairs. The Judiciary and Congress not only do not communicate with each other on their most basic concerns; they do not know how they may properly do so. Legislators enact laws without considering either their burden on the courts or how they might be interpreted. The paradox is that when the Judiciary exercises the powers Congress has thrust upon it, it is reviled as power hungry. Legislators, required to stand periodically for reelection, are suspicious of, antagonistic to, and ever ready to restrain and humble their secure, life-tenured colleagues.

The judges, for their part, facing increasing responsibilities along with criticism for exercising them, and sensitive to ever accreting restrictions and diminishing standards affecting their life and work, are in danger of losing the respect, serenity, and independence that the Constitution sought to vouchsafe. The condition we describe, if not an acute crisis, is that of a chronic, debilitating fever. We therefore dedicate this 86th Federalist paper to both branches and their happier coexistence.

Our Earlier Pronouncements

In No. XLVIII we made so bold as to criticize some of our colonial forerunners for being wary only of the danger to liberty of a grasping hereditary magistrate. We warned of the equal danger from legislative usurpation, pointing out that "the legislative department alone has access to the pockets of the people," thus creating a dependence on the part of the other branches.

In contrast, in No. LXXVIII, we supposed that "the Judiciary . . . will always be the least dangerous to the political rights of the Constitution; because it will be the least in a capacity to annoy or injure them . . . [having] no influence over either the sword or the purse. . . ." We explained that lifetime tenure was necessary both to attract the most able judges and to assure "uniform adherence to the rights of the Constitution, and of individuals." And in No. LXXIX we wrote that the parallel guarantee, the Constitution's provision barring any diminution in judges' compensation, "put it out of the power of [the legislative branch] to change the condition of the individual for the worse."

We now see that we were imperfect prophets. We would not change what we said about the power of the legislative department. But we did not accurately foretell the nature of the Judiciary. We underestimated the impact on society of judicial decisions applying the Constitution and statutes. In the eyes of many, this influence has made the Judiciary a source of danger. Others view it as the last bastion of liberty. We recognize the existence of this deeply felt division of opinion. We should, therefore, not have called the Judiciary "the least dangerous" but the most vulnerable branch. Unlike the persons in the executive and legislative branches, judges are appointed for life to their position and are wholly dependent upon the legislative branch for the maintenance of satisfactory working conditions and emoluments.

What Has Changed

In viewing the progress of our republic over these two centuries we have seen with both humility and pride how well the Constitution has served and still serves its people. What we see is not a cause for basic constitutional change, but rather a need to address nonconstitutional means of improving the institutional relations between Congress and the Judiciary.

That the national interest calls for the very best in judges and legislators has always been true but never more so than in these, your times. The two kinds of officials have grown, under our Constitution, into quite different species. Both share, however, the dubious honor of being the butt of criticism, satire, and caricature. It is equally true that in moments of the gravest stress, as in the squalid Watergate affair, both Congress and the Judiciary were justly perceived as saving strengths for the nation. Yet the corona of approbation is all too short-lived among our unruly and restless populace. This fact takes on new significance in a time when the reservoirs of the ablest candidates for both the bench and the legislature are being drained.

Nearly two hundred years ago we wrote of the limited number of persons endowed with the mind and character to perform complex judicial labors "with utility and dignity." We now realize more than we ever could have imag-

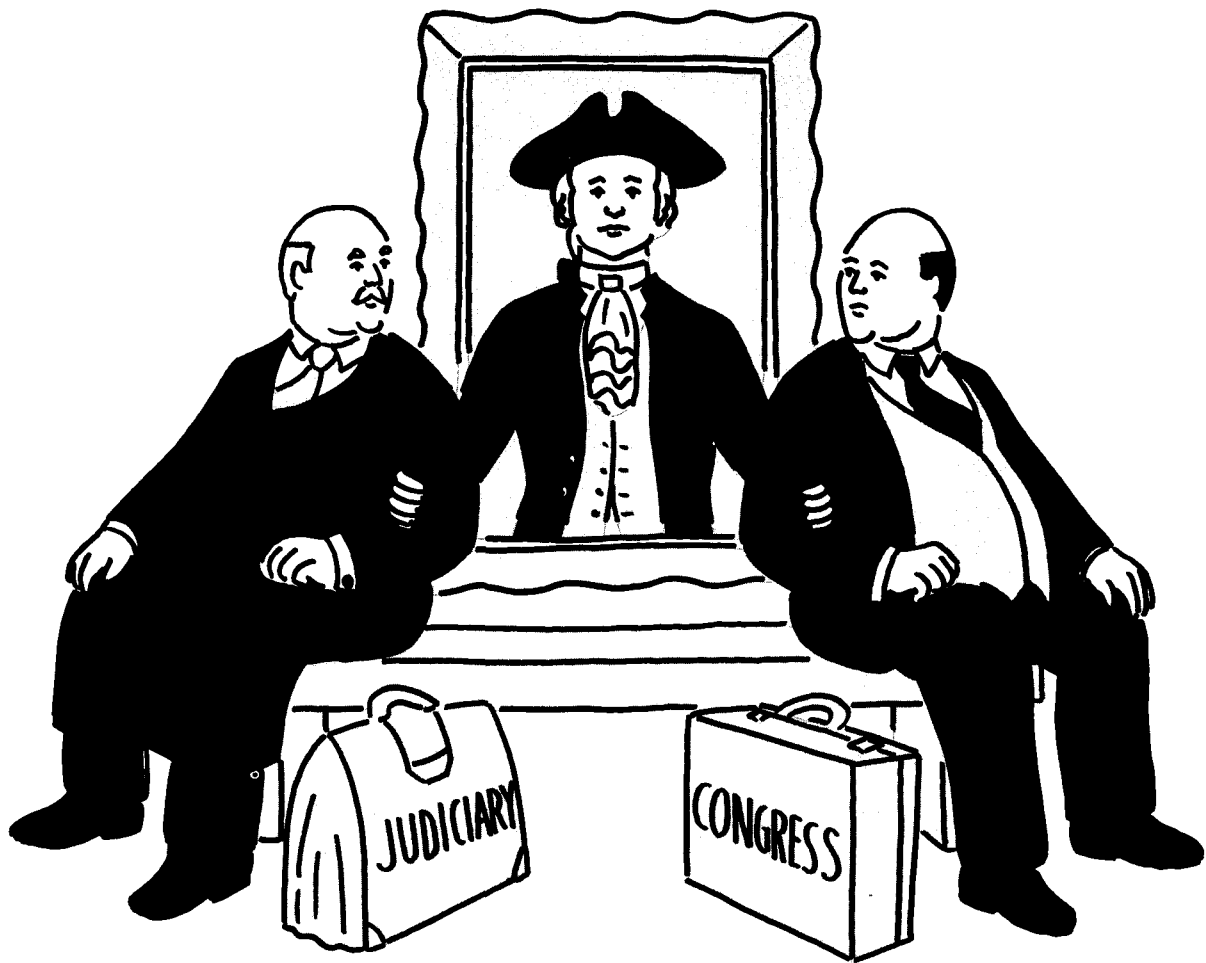
ined how the development of the country and of civilized life has placed the Judiciary in the vortex of conflicting individual and societal values: a sixty-fold increase in the population; the tensions among sectors of the economy; the encroachments on the liberty of the individual necessitated by the interest of all in regulating space, commerce, labor, consumption, the environment; all the complications introduced not only by the industrial revolution but by the post-industrial age; the change in the mores of the people and their varying attitudes — as deeply held and vehemently expressed as ever — on desegregation, abortion, religion, pornography, capital punishment. All of these forces of change have at some point forced the federal Judiciary to resolve bitter disputes, interpret our old Constitution, and in the process advantage or disadvantage either the majority or minorities and individuals.

As the work of the Judiciary has changed, so has its life style. Gone are the days when a Justice Story could also be a bank director. We see that today judges are held to canons of ethics, disciplinary procedures, financial reporting, and standards of disengagement in social, business, and political matters that not even the most monastic of us could have foreseen. Coupled with these developments, an erosion in judges' standard of living for nearly two decades has resulted in more and more judges resigning their office and likely candidates refusing appointment.

If the Judiciary has been affected by two centuries of change, the lineaments of its traditional work are still prominently in place: the highly trained and experienced lawyer-judge, respecting time-honored professional disciplines, deciding actual cases on the basis of his own research and thinking, aided only by a small staff. True, the modern federal Judiciary now has its own bureaucracy, the Administrative Office of the United States Courts. But this office is still a small support staff in a world of giants, handicapped by limited resources and, more particularly, by the absence of clear boundaries of its permissible range of operations.

How different are the work, the pace, and pressures of the senator and representative! Here, too, we have seen a similar shallowing of the reservoir of the ablest political leaders. The demands of campaigning effectively, representing the electorate conscientiously, and legislating responsibly are such as to be exhausting, discouraging some politicians from continuing in office more than a few short years. The catalogue of pressures is both depressing and cataclysmic: the volume, complexity, and variety of new legislation; the proliferation of committees; the growth and escalation in importance of the staffs of members and of committees; the lack of time to read and reflect; the power of special interests and single issue groups; the costs of attaining and retaining office; the distorting demands of television; the increasing rate of turnover and resignations among the members; the near disappearance of the revered veteran statesman; and, most alarming, the erosion of respect for the legislature itself.

These conditions, keenly felt no doubt by all members, have insidious effects on the relationship between the Judiciary and Congress. Harried members can all too easily be goaded to anger by those whose ox a judge has gored. They feel vulnerable to the demagogic criticism of those who would lead an all too willing but unthinking electorate to castigate any effort to improve congressional compensa-



tion. Any such considerations can only be strengthened by a factor we may not have fully anticipated in providing for permanency of judicial tenure—the human tendency of an elected official whose lease on office must be painfully renewed periodically on the hustings to consider a tenured judge so highly favored as to need or deserve no further consideration.

The tensions of the times, it seems clear to us, have thus created an estrangement between the two branches. This has been brought to pass even though most federal judges have been at one time intimately associated with representatives and at least one senator whose sponsorship was a key to his or her appointment to the bench, that a number of judges have served in Congress, and that various committees of the Judiciary and Congress perform discrete functions together harmoniously. The separation, therefore, is an institutional one, and its speedy amelioration is in the best interests of this republic.

Areas of Estrangement

It is not difficult for the interested observer to discern the signs of unnecessary distance between the two branches. We stress “unnecessary,” for we realize that the underpinning of our doctrine of separation of powers is a recognition of man’s inherent self-aggrandizing nature and the necessity of invoking the different interests of the three branches to check and restrain each other—a condition of permanent tension. But just as tensions and disagreements in a workable and enduring marriage do not normally foreshadow

estrangement, so need they not in our constitutional structure.

Here, then, are some of the points of abrasion we have noted. In the torrential floods of new legislation, laws are passed without regard to their impact on judicial resources. Sometimes laws directed solely to changing a part of the judicial establishment are enacted without consulting the affected judges. When deliberations over complex legislation affecting the Judiciary extend over several years, the contribution of thinking from the Judiciary may be solicited only in the earliest stages.

In pointing to the lack of pre-enactment opportunity for the Judiciary to give its views, we do not for a moment exhume the idea of a Council of Revision contained in Resolve 8 of the Virginia Plan, which one of us helped to formulate. This would have required judges to join with the executive in passing on a law’s validity before its enactment. Short of so pronouncing, however, we sense a considerable uncertainty as to how far the Judiciary may properly go in giving its views on the policy of a proposed law, as distinguished from its sheer workability. Issues of policy and issues of workability tend to merge.

At the other end of the spectrum, there would seem to be room for a more systematic and effective way for the legislature to obtain the post-enactment views of the Judiciary, the better to remove obscurity, redundancy, and inconsistencies through amendment. Often these views are contained as holdings or dicta in judicial opinions. But as yet these nuggets, if such they are, are nowhere systematically collected and analyzed. Moreover, there may be other ways

in which the experience of the judges who have dealt with legislation may be made available to Congress.

On occasion legislative efforts are launched to “restrain” or otherwise monitor judges. We do not write of the plethora of efforts to limit the jurisdiction of courts; such attempts have always been made and no doubt will continue so long as there exist differences of views as to what courts should do. What we refer to are efforts to specify in detail how judges should conduct their deliberations, when they should be disqualified from hearing a case, and how they should be disciplined (short of impeachment) for misconduct. There seems to us to be a fine line between the kind of oversight that is proper for Congress to exercise and the kind that encroaches on the ability of judges to practice their calling with independence. Even if saner heads prevail, the very mounting of such efforts seems an unnecessary and corrosive harassment.

Another area, shrouded by the fog of uncertainty, is that of the kind and manner of communications that should be encouraged between Congress and the Judiciary. Just as we wrote in No. XLVIII that the principle of separation of powers “does not require that the legislative, executive, and judiciary departments should be wholly unconnected with each other,” so also we would say that the departments should, consistent with their own mission, seek ways to communicate effectively with each other.

This advice was unneeded when the Constitution was drafted. The entire national government was a small community. In 1789 the Senate consisted of 26, the House of 65, the Judiciary of 19; in 1790, the Department of State had 9 employees. Often the limited lodging arrangements in our new Capital meant that officials of all three branches ate from the same table. With time and growth and increased specialization, communication, except in the most formal

sense, has become a greater problem for the Judiciary and Congress than it has for the executive, whose platoons of liaison representatives regularly walk their beat on Capitol Hill.

The essence of the problem can be summed up by saying that the overarching and simplistic commandment, “Thou shalt not lobby,” does not begin to recognize the multiple levels and purposes of desirable communication in both directions between the two great branches. Worse, the negative nature of the commandment and its criminal sanction chill any effort to explore ways of meeting perceived needs.

The anomalous result is that in an age when Congress is inundated by information and opinion from every group, entity, and individual with an interest in getting a law passed, it hears from the Judiciary chiefly on two occasions: (1) when a legislative committee has formally asked the Judicial Conference of the United States — the policy-making body of the federal Judiciary — for its views on a specific piece of legislation, and (2) when a legislative committee has asked a judicial committee or a judge to testify before it.

Limiting permissible communication to these two channels disserves the Judiciary, Congress, and the citizenry. What if one or many judges have views on legislation contrary to those expressed by the Judicial Conference? Should they be permitted to send those views to the congressional committee or to ask to testify before it? If so, what restraints, if any, should be observed? Should the Conference itself be permitted to communicate its views even though no request has come from a legislative committee? Should a judge or the Judicial Conference be permitted to send views critical of existing legislation? If so, what are the limits of propriety?

May judges prevail on a third party to formally present their views on, for example, the adequacy of their emoluments and other benefits? May judges consult and cooperate with groups of citizens who themselves are committed to working for a Judiciary of quality and independence? If so, what ought to be the ground rules of permissible association and representation?

Turning the coin to its other side, should a legislator ever be permitted to express a concern or opinion in a litigated case of public importance on trial or on appeal? If so, under what conditions and restraints? How should a senator or a representative communicate complaints of possible misconduct by a judge? Should a legislator and a judge be permitted to communicate directly with each other on legislation, new or old? On the repair or construction of court facilities? On candidates for judicial office? Should legislators and judges within a state or region be encouraged to meet formally and informally? If so, how can the boundaries of propriety best be defined and preserved?

Finally, in the critical forum of judicial confirmation hearings, is it possible to arrive at a consensus on the kinds of questions from legislators and answers from judges that properly serve the legitimate interests of the interrogators without trenching upon the dignity, impartiality, and independence of the judicial nominee? By consensus we do not mean a catalogue of proper and improper questions but rather an atmosphere of inquiry flowing from a basic shared value that asking for prejudgments on specific issues endangers the quality and independence of judges so catechized.

*“... the overarching and
simplistic commandment,
‘Thou shalt not lobby,’
does not begin to recognize the
multiple levels and purposes of
desirable communication. . . .”*

A Call for All Feasible Reconciliation

Having had some two hundred years to reflect on our earlier writings, we realize that we may have made too much of our mentor, Baron de Montesquieu. We blush a bit in recalling what we said in No. XLVII: "The British Constitution was to Montesquieu what Homer has been to the didactic writers on epic poetry" — particularly since we quoted him as characterizing the British king, rather than the prime minister, as the "sole executive magistrate." Nevertheless, we realize that we, though acknowledging him as our "oracle," were creating a system of government quite different from that in our erstwhile mother country.

The separation of powers set out in our Constitution is, we can justly proclaim, our own invention. With two centuries of experience to survey, including wars foreign and domestic, depressions, and scandals, we feel humbly proud of the proven worth of the concept. But we also sense that the time has come to attempt to soften the edges where the Judiciary and Congress rub. Not, we are quick to say, through constitutional changes. We are in entire accord with the homely philosophy, "If it isn't broken, why fix it?" On the other hand, if something, although not broken, shows the sign of strain, we deem it only prudent to try to ease that tension. So we commend to your good judgment the finer tuning that can be brought about by a new consensus and some new practices and procedures.

The key to such a limited effort is process. As we look back on our experiences in Philadelphia, the process really began with reading not only Montesquieu's *L'Esprit des lois*, other books, and the constitutions of the various States, but reflecting on our experience under the Articles of Confederation. It continued, as you know, with a bountiful measure of written proposals. And both our reading and our writing were hammered into shape on the anvil of months of discussion and debate. Of course, we were discussing momentous propositions. But although Michelangelo's towering David represents a prodigious investment of time, talent, and energy, so also does Bellini's loaf-sized Salt Cellar of Francis I.

The starting point for a constructive process is asking the right questions. This suits us well, for at this juncture we have only questions on improving relations between the Judiciary and Congress; indeed, if we had answers, there would be no need for the process we have described. We would begin by a look backward. What was the nature of communication and relationships between the makers and the adjudicators of law at the birth of our nation? What can be discerned about our intent? What changes have taken place during these two centuries?

Then we would be most interested in a look at the present: what perceptions, assumptions, and biases does each branch harbor about the other; what ones are both false and harmful; how can they best be changed?

Such an examination would clear the building site of underbrush and accumulated debris. We would then think it desirable to undertake three major lines of inquiry. The first would delve into the principle of separation of powers and the multitude of situations in which it is invoked. The objective would be to identify the kinds of issues, functions, hazards, and benefits that dictate the most absolute or "pure" separation; those that merit a less than complete separation; and those where the advan-

tages of collaboration and ease of communication far outweigh those of separation. Out of such an inquiry might happily emerge certain standards or criteria that could guide future relationships between these two branches.

A second inquiry, more detailed than the first, would survey the existing ways in which courts participate in the legislative process and the ways in which Congress directly and indirectly affects the judicial process; such a survey would attempt to devise meaningful categories, such as general legislation, justice-oriented legislation, court and judge-oriented legislation; the areas of frustration felt by each as the result of actions of the other; the present levels and modes of communication; the organizational structure and procedures of each that help or hinder effective communication.

The third inquiry, built upon the first two, would be a search for improved ways of communicating and acting, honoring separation where separation is called for, but encouraging communication and even collaboration where such are permissible. This study would draw upon the experience of the States and even other countries; it would seek ways to strengthen and broaden the structural capacity of the courts to initiate communications with and respond to communications from Congress, utilizing various levels, modes, and procedures. It would seek ways in which Congress could take advantage of judicial experience in interpreting various statutes, minimize risks of judicial misinterpretation of legislative history, and avoid the fortuitous imposition of unintended burdens on courts. This pragmatic search for improved methods of conducting the law-creating business of the nation would, in our view, also embrace ways to stimulate a greater community of interest and shared respect. We can still learn from Britain — no longer from its institutions but from the camaraderie of social intercourse that occasionally envelops cabinet ministers, members of Parliament, and even judges. Is there a need for facilities and provisions for occasional meetings, and social and educational programs? If so, what kind?

As we view this task of tuning the organs of our government, we hark back to the words of the philosopher Hume with which we closed our last appeal to the public in No. LXXXV. Observing that attaining the right balance in any large society is beyond the reach of the reflection and reason even of genius, Hume then wrote: "The judgments of many must unite in the work; experience must guide their labor; time must bring it to perfection, and the feeling of inconveniences must correct the mistakes which they inevitably fall into, in their first trials and experiments." After two hundred years it is not too early to let "the feeling of inconveniences" help correct mistakes. We wish you well.

— Publius

Note: The Brookings Institution, with the support of the Judicial Conference Committee on the Judicial Branch, has under way a research project, under the leadership of Senior Fellow Robert Katzmann, to explore ways to improve relationships between the legislative and judicial branches of the federal government. The Culpeper Foundation has generously supplied funding for this research and writing. A colloquium of scholars and practitioners will be held on November 13, 1986, with the assistance of senior staff member Warren Cikins.

Preserving Federalism: Congress, the States, and the Supreme Court

Martha Derthick

WHEN THE Supreme Court early in 1985 reversed a decision of 1976 and decided that state and local governments must, after all, abide by federal regulation of wages and hours, it developed two main lines of argument. One was that it is difficult to define a sphere in which state governments are protected from the reach of the commerce clause. The other, and more fundamental of the two, was that the Supreme Court has no business trying.

The second argument asserts that structural features inherent in the national government, principally the representation of states in the U.S. Senate, provide adequate protection for the states' interests. And it points to alleged successes of the states, principally the volume of grants-in-aid, as concrete evidence of their power in national politics. For scholarly support, it draws on one relatively old law journal article, "The Political Safeguards of Federalism" by Herbert Wechsler (1954), and one much newer book, *Judicial Review and the National Political Process* (1980), by Jesse H. Choper, a law professor at Berkeley.¹

One wonders why, if the states' interests are so well protected by the political branches, the issue of Congress's right to regulate the wages and hours of their employees reached the Supreme Court at all. It arose because Congress in 1974 extended the Fair Labor Standards Act, which since 1938 has regulated wages and hours in much of the private economy, to cover all state and local government employment as well. An earlier Congress had covered certain categories of state and local workers—those employed in schools, hospitals, and other institutions—and in 1968 the Supreme Court had upheld the validity of its action in a case brought by Maryland.² But when Congress extended the act again, a 5-4 majority of the Court found its action unconstitutional, ruling in *National League of Cities v. Usery* (1976) that Congress could not "operate to directly displace the states' freedom to structure integral operations in areas of traditional governmental functions."³ In the interim, the Court had been significantly altered by the addition of four Nixon appointees—Chief Justice Warren E. Burger and Justices Lewis F. Powell, Jr., William H. Rehnquist, and Harry A. Blackmun—who joined with Potter Stewart to constitute the majority in the case. (President Ford's one appointee to the Court, Justice John Paul Stevens, was in the minority.)

Although congressional debate over the legislation in 1973 and 1974 did not completely ignore its likely effects on state and local governments or the implications in principle for federalism, it paid far more attention to the economic and social consequences of the bill as a whole—its effects, for example, on youth unemployment and the rate of inflation. Not surprisingly, Congress generally enacts social policies with an eye mainly on social and economic outcomes, giving only secondary consideration to the consequences for constitutional principles or the structure of government institutions.⁴ The legislation abolished exemptions from the Fair Labor Standards Act generally, not just those applying to

Martha Derthick is the Julia Allen Cooper Professor of Government and Foreign Affairs at the University of Virginia. A former director of Brookings' Governmental Studies program, she is the author of four Brookings books, the latest of which (co-authored with Paul J. Quirk) is *The Politics of Deregulation* (1985). She teaches courses on intergovernmental relations in the United States and has written several books on that subject. The author wishes to thank David R. Beam, James W. Ceaser, Robert A. Katzmann, Richard P. Nathan, and David M. O'Brien for comments, while absolving them of any responsibility for the contents.

state and local government, besides increasing the minimum wage. President Nixon's successful veto of it in 1973 rested mainly on the grounds that it would contribute to inflation and unemployment and harm the disadvantaged. That it was "an unwarranted interference with state prerogatives" entered late and only incidentally into his veto message.⁵ During the debate of 1974, spokesmen for state and local governments in Congress made no effort to preserve a general exemption for them but sought merely to exempt firemen and policemen from the provisions governing overtime. The House agreed to this exemption, but the Senate defeated it by a vote of 65-29, and Nixon this time signed the bill.

Taking note of the Senate's vote, Choper carefully constructs an argument that, because senators must stand the test of election, their votes more truly reflected the "opinion" of the "states" than briefs filed by 22 attorneys general who asked the Court to invalidate application of the Fair Labor Standards Act to state and local employees. Choper looks specifically at the votes of the senators from those 22 states and finds that in seven of them both senators voted to cover the overtime of police and firemen; in ten the vote was split; and in only three, Delaware, Nebraska, and Oklahoma, did both senators vote to exempt police and firemen. (In the remaining two states, only one senator voted — one in favor of national regulation, the other against it.)⁶

Choper does not acknowledge the possibility that the senators who voted for coverage were responding to the interests of active, well organized public employee unions, or at least that they were deferring to a committee with a pronounced pro-labor bias — the Committee on Labor and Public Welfare. Nor does he argue that "truly" representing the "opinion" of the "states," if that is what the senators were doing, is the equivalent of adequately protecting the states' role and interests as governments in the federal system. Let us grant that senators are sensitive to the preferences of the states' voters; what ground is there for supposing that the voters, or the portion of them that is active and concerned on any given issue, will attach value to preserving the federal system?

The Court's opinion of 1985 in *Garcia v. San Antonio Metropolitan Transit Authority*, in which a 5-4 majority overruled *National League of Cities v. Usery* (Blackmun having joined the other side), raises fresh doubt about the value attached to federalism within the Court. The plaintiff was a local transit authority employee seeking to collect overtime pay. A federal district court ruled against him, finding that San Antonio's operation of a mass transit system was a traditional governmental function and thus exempt from the Fair Labor Standards Act under the Court's ruling in 1976. Although the majority in *Garcia* said that there are undoubtedly limits on the federal government's power under the commerce clause to interfere with state functions, it was unwilling to carry on an effort to define what they might be. "State sovereign interests," it said, "... are more properly protected by safeguards inherent in the structure of the federal system than by judicially created limitations on federal power."⁷ Choper, whom the opinion cited in support of this point, asserts that federalism cases raise questions of practicability only, whereas individual rights cases are matters of principle.⁸

The defenders of federalism within the Court, in this case a minority consisting of Burger, Powell, Rehnquist,

and President Reagan's one appointee, Sandra Day O'Connor, insist that federalism is indispensable to the constitutional scheme, that it promotes democratic self-government, and that the Court has a constitutional responsibility to define and protect the essentials of state sovereignty. If it abdicates, the only protection for the states will lie in Congress's "underdeveloped capacity for self-restraint," in Justice O'Connor's caustic phrase.⁹

To the extent that this dispute within the Court turns on differing interpretations of our constitutional history and differing perceptions of the value of federalism, there is probably not much an outsider can add. However, to the degree that it revolves around the political propensities of the contemporary Congress, political scientists ought to be able to help. Can Congress be relied on to protect the states? Is the large volume of grants-in-aid a credible indicator of the states' power in national politics? As a practical matter, who is more nearly correct? Is it Justice O'Connor, believing that the balance of power in our governmental system has shifted to the national side, or the *Garcia* majority, asserting that "the political process ensures that laws that unduly burden the states will not be promulgated"?¹⁰

The Forces of Centralization

The founding generation recognized that the government it had created, being a compound of unitary and federal features, could prove unstable. "It will be fortunate," James Madison wrote in 1828, when instability was already manifest, "if the struggle should end in a permanent equilibrium of powers. . . ." ¹¹ The Anti-Federalists had gloomily predicted that the national side would win out, and, from the perspective of 1986, surely everyone must agree that they were right.

The Constitution itself, if only by incorporating the supremacy clause, has a national bias, reflecting the outcome of the original contest. The Tenth Amendment has proved a weak defense for the states, being not a rule of law, but merely, as Walter Berns has written, an "accessory to interpretation."¹² Not even the warmest friends of the states rely heavily on it but often resort instead to "principles inherent in the constitutional scheme."

The Supreme Court has stood with the national side through much of our history — plainly before 1837 and since 1937, much more ambiguously in the hundred intervening years. Yet even in that constitutional era to which Edward S. Corwin applied the curious label "dual federalism," the Court endorsed many extensions of the reach of the commerce clause. With the end of that era, it ceased acting as an impartial arbiter between the two levels of government and instead emerged, at least in the Warren years, as an aggressively nationalizing force in its own right.¹³

Economic, social, and technological developments have been powerful forces for centralization as well. Federalism is not a constitutional principle only. It rests on social and economic foundations, and as the country becomes more homogeneous socially and interdependent economically, federal legislation follows inexorably.

Against such forces (and my list does not even mention the application of military power in the Civil War), the structural protections for the states built into the Constitution appear unavailing and themselves badly eroded by

"One wonders why, if the states' interests are so well protected by the political branches, the issue of Congress's right to regulate the wages and hours of their employees reached the Supreme Court at all."

time. Though Choper argues that the presidency contributes to protecting the states, even he discounts the importance of today's electoral college. The president sympathizes with the states, Choper argues, because he must in order to maintain good relations with a Congress that retains "binding local ties." He cites President Carter's early conflict with Congress over funding of federal water projects as an example of continued congressional vigilance in defense of localities.¹⁴ Such vigilance is not in doubt. What is dubious is Choper's casual propensity to presume that any constituency-based interest can be equated with the interests of state governments as elements of the federal system.

Those who argue that Congress reliably protects the states' interests emphasize the structure of the Senate, in which the states are formally and equally represented, but they rarely pause to inquire whether equal representation assures effective representation. It did not do so in the case of the Fair Labor Standards Act amendments in 1974, when the House was more responsive to the states' interests than was the Senate, and there is really no reason why it ever should. After popular election replaced election by state legislatures in 1913, senators ceased to be under any constraint to protect the functions of state governments. Even though their electorates are defined by state boundaries, senators need not define state governments as crucial components of their constituencies. Moreover, by giving these state delegates long terms and freeing them from the necessity of voting as units (as senatorial delegations had been required to do under the Articles of Confederation), the founders initially gave them more freedom than is generally recognized.

In sum, the forces of centralization, barely sketched here, appear to be overwhelming, while the built-in protections for the states are enfeebled. In view of this, it is necessary to ask why the states remain vigorous. At least since Woodrow Wilson's time, the states have repeatedly been declared to be dying, yet they seem never to be dead. Recurrently, commentators detect in them a "new vitality." "The States Are Leading as Washington Wallows," said a headline in the Outlook section of the *Washington Post* last fall. Beneath the

headline, two resident scholars at the American Enterprise Institute proceeded to document the competence and energy of today's state governments.¹⁵ Surely this capacity for survival testifies to the states' power at the national level.

In a sense it does, but that power, which I believe to be great, does not flow from the scheme of representation. It flows from Congress's dependence on the states. Congress needs them to share the burdens of governing.

Sources of State Power

Congress attempts so much that it is easy to overlook how much it ignores. While few important matters escape it forever, even fewer are not dealt with first in the states. They remain laboratories. Consider the following items:

— Montana in October 1985 became the first state to implement legislation requiring that prices and benefits for all forms of insurance be the same for men and women. A proposed federal law mandating unisex insurance policies nationwide passed a House subcommittee in 1983 but then died. "Montana will be the laboratory for this policy idea," an attorney with the American Council of Life Insurance told the *Washington Post*. Five states require that auto insurance rates be the same for both sexes.¹⁶

— The *Wall Street Journal*, in a story on the unreliability of computer software, reported last October that efforts were under way in five states to pass consumer protection laws specifically for the benefit of computer users. A member of the California State Assembly had proposed a bill to set truth-in-advertising standards, require refunds and warranties, and, in some cases, allow civil damage suits.¹⁷

— In the past eight years, 33 states have begun to restore wildlife species to former habitats. The states are spending millions of dollars, most of it raised from state residents who agree to divert part of their income tax refunds to the purpose. As a result of this effort bighorn sheep are back in Oregon's mountains, beavers in Ohio's rivers, and peregrine falcons in California's skies.¹⁸

— Andrea Bonnicksen and Edward Brazil of Eastern Illinois University report that 24 states have adopted laws

dealing with artificial insemination by donors, several states have laws directly or indirectly regulating in vitro fertilization, and ten states forbid women to sell a fetus for experimentation, laws that could be construed as forbidding ovum transfer, which Bonnicksen and Brazil identify as a third method of "alternative conception."¹⁹

These examples should suffice to demonstrate that the states remain active on the frontiers of domestic questions, but it is not only the frontiers that occupy them. Consider yet another news story:

— An alliance between liberals and conservatives in California has initiated a work-for-welfare program that "many experts expect to become standard nationwide," the *Washington Post* reported last September. Californians had been inspired in part by a tour of "innovative welfare programs in Massachusetts, West Virginia, and Pennsylvania." Hardly a new issue, welfare is a traditional responsibility of the states, in which federal involvement has grown steadily since passage of the Social Security Act in 1935. However, major efforts at completing the process of nationalization were unsuccessful in the 1970s, and left the Washington participants exhausted. It is remarkable to see welfare reform rising anew from the states, albeit in this instance under federal prodding.²⁰

If news stories seem an insufficiently dependable source of information about what the states are doing — subject, conceivably, to the influence of the states' own publicists or to journalism's tendency to exaggerate what is "new" — then let us turn to a study of the California legislature by Professor William K. Muir, Jr., of Berkeley. In what is surely one of the best books ever published about a legislative body, Muir writes that the California legislature in 1975–76 passed over 2,570 laws, among which were: the nation's first agricultural labor relations act; a complete restructuring of prison sentencing; public school teachers' collective bargaining legislation; a \$600 million increase in annual unemployment insurance taxes; a significant tort and professional reform in the area of medical malpractice; a program to subsidize the construction of low-income, privately-owned housing; a complex scheme for regulating all building construction within a thousand-mile-long coastal zone; a comprehensive reform of eminent domain legislation; a pathbreaking and stringent nuclear energy safety act; the first euthanasia (or right-to-die) law in the United States; elimination of an oil-depletion income-tax deduction; a new basis for taxing timber; decriminalization of both marijuana use and private adult sex acts; and provision of unemployment insurance to farmworkers. In summary, the author says, its agenda outside of foreign affairs, defense, immigration, and monetary power was "boundless." It made laws relating to every domestic matter except the post office.²¹

California's legislature is not typical, nor was 1975–76 a typical year even for it. Still, this information is reliable enough as an indicator of the scope of the legislative burden from which Congress is routinely relieved by reason of the state legislatures' existence.

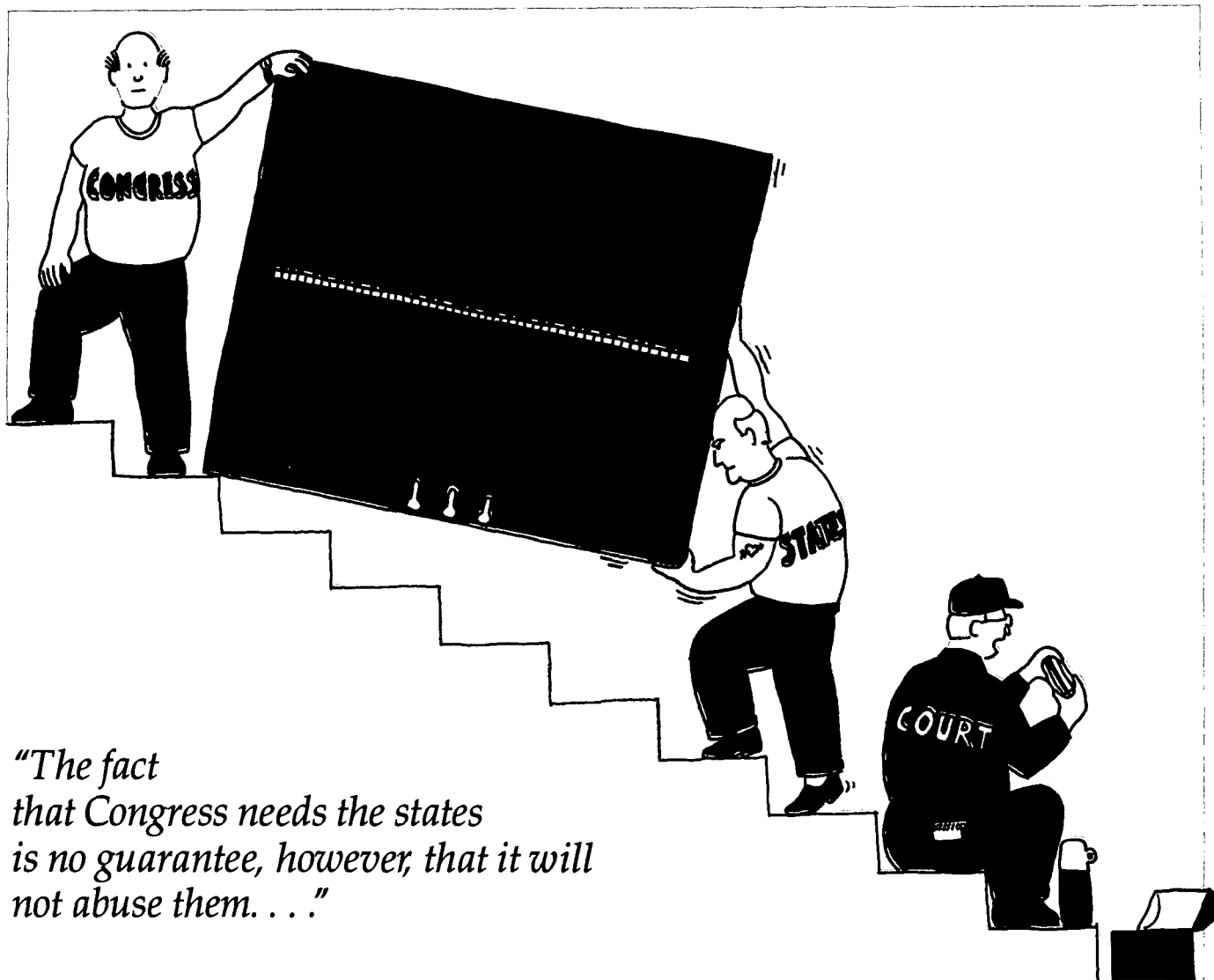
In short, the states help Congress out by tackling novel policy issues and by continuing to handle many familiar problems that Congress either chooses to ignore or, as with welfare, fails to find a national solution for. And, of course, the states can adapt policy to local preferences and circumstances: the laws California enacts governing pri-

*"Those who argue
that Congress reliably protects
the states' interests
emphasize the structure of the
Senate, . . . but they rarely pause
to inquire whether equal
representation assures effective
representation."*

vate sex acts and coastal development need not suit Georgia.

Congress is already overwhelmed. Consider how much worse off it would be if the state legislatures did not exist. The inability of Congress to do more is an important source of protection for the states, and in a certain sense stems from their power. They are powerful simply because they are functioning, legitimate governments in a country that now requires, or at any rate submits to, a very large amount of governing indeed.

Congress depends on the states for more than legislation. It relies heavily on them as well for administration, an aspect of the grant-in-aid relations overlooked by those who interpret the volume of federal grants as simply a measure of the states' ability to raid the federal Treasury. (Revenue-sharing might plausibly be interpreted as a raid, but as such it failed. Revenue-sharing to the states ended in 1981, and the Reagan administration appears likely to succeed in ending local revenue-sharing as well.) Congress has habitually chosen the medium of grants not so much because it loves the states more as because it loves the federal bureaucracy less. Congress loves action — it thrives on policy proclamation and goal-setting — but it hates bureaucracy and taxes, which are the instruments of action. Overwhelmingly, it has resolved this dilemma by turning over the bulk of administration to the state governments or any organizational



*"The fact
that Congress needs the states
is no guarantee, however, that it will
not abuse them. . . ."*

instrumentality it can lay its hands on whose employees are not counted on the federal payroll.

Upon examination, the power of the states in the governing sphere comes to resemble the power of the corporation in the private sphere. Political scientists of left-liberal views are fond of pointing out, quite correctly, that the need to keep the economy functioning introduces a subtle and pervasive pro-business bias into our politics.²² There is a similar bias in favor of the states, arising out of the need to keep our governmental system functioning. The bias arises both from the legislative actions Congress does not take and from its deliberate choices of administrative strategies.

The Need for Judicial Scrutiny

The fact that Congress needs the states is no guarantee, however, that it will not abuse them, just as its dependence on corporations for productivity is no guarantee that it will not abuse them. In particular, there is a danger that Congress, in striving to close the gap between its desire to define large goals and its unwillingness to provide the administrative means to achieve them, will try to conscript the

states. That is, it will give orders to them as if they were administrative agents of the national government while expecting state officials and electorates to bear whatever costs ensue. In a number of the new regulatory programs of the 1970s, Congress moved distinctly in that direction. In the Clean Air Act of 1970, for example, it addressed the states with the language of command—each state "shall" adopt a plan for controlling air pollution—a striking departure from customary constitutional forms.²³

Like Congress, federal courts have been uninhibited by federalist principles as they have ordered the states to conform to newly-discovered requirements of the equal protection and due process clauses of the Fourteenth Amendment. In the process, they often have imposed heavy burdens of expenditure—as in the so-called "institution" cases, in which numerous states were required to overhaul institutions for the mentally ill or retarded, prison systems, and juvenile detention systems.²⁴ Yet courts have also protected states from the more extreme commands of Congress or, at any rate, of an administrative agency acting under what it took to be authority granted by Congress.

Under the transportation and land-use provisions of the

Clean Air Act of 1970, the Environmental Protection Agency tried to compel the states to impose stringent regulations on private parties. These included such measures as gasoline rationing, parking surcharges, and review and approval of construction of parking facilities. EPA claimed that the states' failure to comply would justify the imposition of such sanctions as "injunctive relief, imposing a receivership on certain state functions, holding a state official in civil contempt with a substantial daily fine until compliance is secured, and requiring a state to allocate funds from one portion of its budget to another in order to finance the undertakings required by the agency."²⁵

Whether Congress had authorized this approach was unclear. One circuit court concluded that it had, whereas three others preferred to believe that it had not. Beyond ruling that the EPA had exceeded its statutory authority, the three strongly intimated that its actions were unconstitutional as well. In a lengthy discussion of constitutional issues, the Ninth Circuit held that a state could decline to enforce a federally prescribed program of regulation without becoming liable to sanctions, and hinted that EPA's effort to compel state action in this instance might have violated the Tenth Amendment and Article IV, Section 4, which obligates the United States to guarantee to every state a republican form of government.²⁶

The circuit courts stood in the way of federal conscription of the states on this occasion, and by the time any of the cases reached the Supreme Court, EPA had retreated far enough to make them moot. But it would be rash to assume that the Supreme Court need not be ready to respond to comparable challenges to the states at other times.

To admonish the Court to be ready of course constitutes no help with the practical question of what standards it should apply in the states' defense. For those who believe, in contrast to Professor Choper, that federalism is a constitutional principle of the United States, the articulation of such standards ought to be an intellectual objective of high priority.²⁷

1. Herbert Wechsler, "The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government," *Columbia Law Review*, vol. 54 (1954); Jesse H. Choper, *Judicial Review and the National Political Process: A Functional Reconsideration of the Role of the Supreme Court* (University of Chicago Press, 1980).

2. *Maryland v. Wirtz*, 392 U.S. 183 (1968).

3. *National League of Cities v. Usery*, 426 U.S. 833 (1976), at 852.

4. For a painstaking, erudite argument that Congress has yielded to "judicial monopoly" in the determination of constitutional questions, see Donald G. Morgan, *Congress and the Constitution: A Study of Responsibility* (Harvard University Press, 1966).

5. *Congressional Record*, vol. 119, 93 Cong. 1 sess. (1973), p. 37718.

6. Choper, *Judicial Review*, pp. 182–83.

7. *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 000; slip opinion 82–1913 (1985), p. 23.

8. Choper, *Judicial Review*, pp. 201–3.

9. *Garcia*, slip opinion, dissent, p. 9.

10. *Ibid.*, slip opinion, p. 27.

11. *The Letters and Other Writings of James Madison* (Congress edition: R. Worthington, 1884), vol. III, p. 625. The *Garcia* majority quotes Madison selectively in support of its view that adequate restraints on the power of Congress inhere in the composition of the federal government and do not depend on judicial

interpretation. See slip opinion, pp. 22–23. But there is abundant evidence in Madison's writing that he expected the Supreme Court to settle federalism controversies. The most important and accessible statement is in *Federalist* No. 39 (Modern Library ed.), p. 249. Madison, who was nothing if not an astute political analyst, would in any case have wanted his interpreters to take account of subsequent changes in the constitutional system before applying his advice.

12. Walter Berns, "The Meaning of the Tenth Amendment," in Robert A. Goldwin, ed., *A Nation of States* (Rand McNally, 1963), p. 132.

13. Edward S. Corwin, "The Passing of Dual Federalism," *Virginia Law Review*, vol. 36 (1950); David Fellman, "The Nationalization of American Civil Liberties," in M. Judd Harmon, ed., *Essays on the Constitution of the United States* (Kennikat Press, 1978), pp. 49–60.

14. Choper, *Judicial Review*, pp. 179–80.

15. Denis P. Doyle and Terry W. Hartle, *Washington Post*, September 8, 1985. See also their *Excellence in Education: The States Take Charge* (American Enterprise Institute for Public Policy Research, 1985).

16. T. R. Reid, "Montana Implements Policy of 'Unisex' Insurance," *Washington Post*, October 1, 1985.

17. Dennis Kneale, "Buyer Beware: Software Plagued by Poor Quality and Poor Service," *Wall Street Journal*, October 2, 1985.

18. Larry Green, "States Exchanging Wild Animals," *Washington Post*, December 28, 1985.

19. Andrea Bonnicksen and Edward Brazil, "The Policy of Alternative Conception: Looking to the States," prepared for delivery at the 1985 annual meeting of the American Political Science Association.

20. Jay Mathews, "California Work-for-Welfare Plan Viewed as Model," *Washington Post*, September 24, 1985. In 1981 and 1982 the Reagan administration sought to require, as a condition of grants-in-aid under Aid to Families with Dependent Children, that the states establish work programs for recipients. Congress made such programs optional for the states and spelled out several alternative approaches from among which they might choose. States responded with a flurry of initiatives. Julie Kosterlitz, "Liberals and Conservatives Share Goals, Differ on Details of Work for Welfare," *National Journal*, October 26, 1985, pp. 2418–22.

21. William K. Muir, Jr., *Legislature: California's School for Politics* (The University of Chicago Press, 1982), p. 14.

22. Charles E. Lindblom, *Politics and Markets* (Basic Books, 1977).

23. 84 *Stat.* 1676 (1970). See the discussion in Mel Dubnick and Alan Gitelson, "Nationalizing State Policies," in Jerome J. Hanus, ed., *The Nationalization of State Government* (D. C. Heath, 1981), pp. 56–59.

24. Gerald E. Frug, "The Judicial Power of the Purse," *University of Pennsylvania Law Review*, vol. 126 (April 1978), pp. 715–94.

25. *Brown v. Environmental Protection Agency*, 521 F.2d 827 (1975), at 831.

26. *Ibid.*, 837ff., and *District of Columbia v. Train*, 521 F.2d 971 (1975), at 992–94. However, only the most extreme and unprecedented intrusions on the states, which these EPA regulations represented, have failed to win judicial assent. Grant-in-aid conditions have invariably been upheld, for courts invariably find that Congress is pursuing a valid national purpose and that the states are not subject to coercion (inasmuch as they have the option of declining the grant).

27. See Robert F. Nagel, "Federalism as a Fundamental Value: National League of Cities in Perspective," *Supreme Court Review* (1981), pp. 81–109, for a sympathetic interpretation of the Court's decision in 1976 and an argument that jurists and scholars have been far less creative in defense of "structural values" (the principles that allocate decision-making responsibility among governmental units) than of individual rights.



Richard G. Darman

February Board Meeting

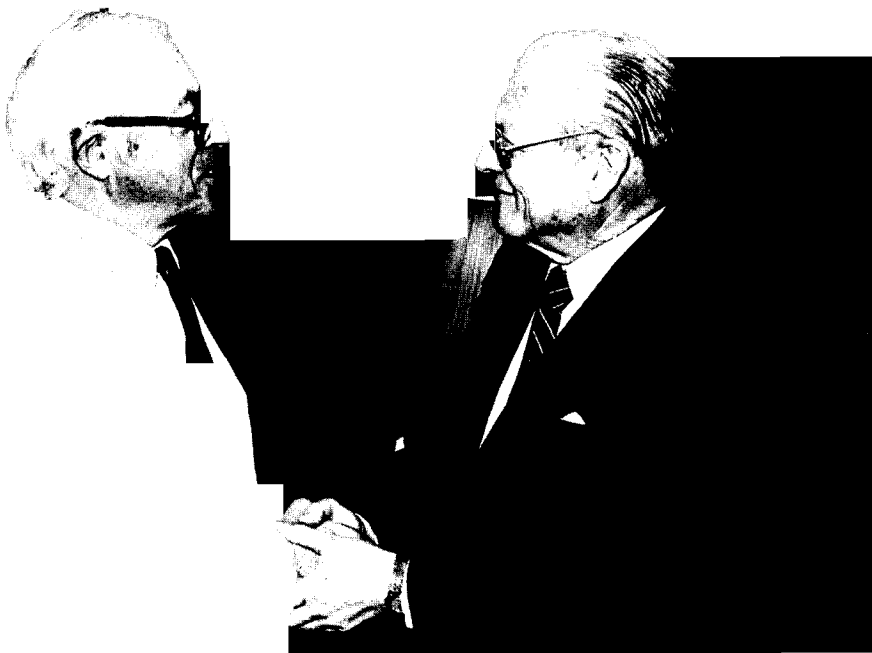
RICHARD G. DARMAN, deputy secretary of the Treasury, was the dinner speaker at the February meeting of the Brookings board of trustees in Washington, D.C. He provided a witty and candid assessment of the Reagan administration's economic policies and the analysis of them by policy research institutions.

Howard R. Swearer, president of Brown University; A. Lee Fritschler, director of the Brookings Center for Public Policy Education; Susan Fritschler; and Roy M. Huffington, chairman of the board, Roy M. Huffington, Inc.



Cecile Zilkha; Ezra K. Zilkha, president, Zilkha & Sons, Inc.; and Walter Y. Elisha, chairman and chief executive officer of Springs Industries, Inc.





Louis W. Cabot, chairman-elect of the Brookings board of trustees and chairman of the board of the Cabot Corporation; and Frank T. Cary.

River Club Luncheon

FRANK T. CARY, a Brookings trustee and the chairman of the executive committee of International Business Machines Corporation, hosted a luncheon at New York's River Club to introduce distinguished business leaders in the New York City area to the Brookings board of trustees and the Brookings Council. Alice M. Rivlin, director of the Economic Studies program at Brookings, spoke to the group about strategies for building a stronger American economy.



Alice M. Rivlin.



Robert M. Fomon, chairman and chief executive officer of E.F. Hutton Group, Inc.; John F. Bookout, president and chief executive of Shell Oil Company; and Cary.

Administration of Justice

CHIEF JUSTICE Warren E. Burger, Attorney General Edwin Meese III, members of the House and Senate Judiciary Committees, and more than 90 other distinguished jurists and government officials attended a Conference on the Administration of Justice in Annapolis, Md. The conference, the eighth in a series, was sponsored by the Brookings Center for Public Policy Education. It was designed to encourage the informal exchange among participants of ideas and perspectives on common problems. Among the topics under discussion were tort liability, implementation of the Comprehensive Crime Control Act of 1984, judicial selection, and the proposed establishment of an intercircuit panel.



Photographs by Robert Burgess



Attorney General Edwin Meese III and Chief Justice Warren E. Burger.

Representative Bill McCollum of Florida; Representative Hamilton Fish, Jr., of New York, ranking member of the House Judiciary Committee; A. Lee Fritschler, director of the Center; and Bruce K. MacLaury, president of Brookings.

Brookings Names New Vice President

JOHAN M. HILLS has been named vice president for external affairs of the Brookings Institution. He succeeds Roger D. Semerad, who left Brookings to become assistant secretary of labor for employment and training. Hills has been vice president for resource development at Roanoke College in Salem, Va., since 1977. At Brookings he will direct the development and public affairs offices and be involved in planning and institutional management. Prior to his work at Roanoke College, Hills was director of development and major resources at the University of Maryland from 1974-77 and regional director of the capital campaign at Georgetown University from 1972-74.



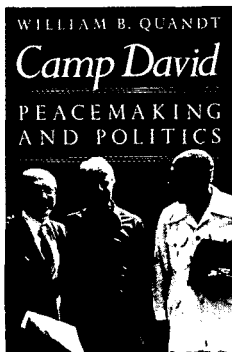
Photograph by Susan Johnson

Constraints on Carter at Camp David

Camp David: Peacemaking and Politics

By William B. Quandt

\$12.95 paper; \$32.95 cloth.



THE MIDDLE EAST occupied President Jimmy Carter's time and energies more than any other foreign policy issue. He personally drafted the first version of the Egyptian-Israeli agreement at Camp David and twice put his political reputation on the line by engaging in summit negotiations that could have failed. In the end, he was able to preside over the signing of the Egyptian-Israeli peace treaty, perhaps the most noteworthy foreign policy achievement of his administration.

Yet Carter gained little in domestic political terms for these efforts, and some would argue that he even weakened his political base, says William B. Quandt in a new Brookings study, *Camp David: Peacemaking and Politics*. Quandt is a senior fellow in the Brookings Foreign Policy Studies program and acting director of that program. He served on the National Security Council staff from 1977 to mid-1979, with special responsibility for the Middle East, and participated in the Camp David negotiations.

"The role that Jimmy Carter played in the Camp David Accords and the Egyptian-Israeli peace treaty shows that determined presidential leadership can help to resolve complex international disputes," Quandt writes. "But Carter had hoped to do even more, especially on the sensitive Palestinian issue. That he was unable to achieve his more ambitious goals was not only due to the intractability of the problem; he was also weakened by the normal workings of the American political system, which force a first-term president to devote enormous time and energy to his reelection campaign." An analysis of Camp David reveals both the power of the presidency in foreign policy and its limitations, Quandt says.

Believing the Middle East dispute to be closely related to both the energy crisis and the danger of superpower confrontation, Carter had a strong interest in undertaking Middle East peace initiatives. He was openly committed to an active American role in trying to break the deadlock in Arab-Israeli peace negotiations and he believed that men of good will could resolve problems by talking to one another.

Carter's popularity was at a low point in the spring of 1978 after his decision to sell F-15s to Saudi Arabia brought him into sharp conflict with the Jewish community. "As Carter felt his political fortunes slipping, he probably began to see a success in the Middle East as a way to recover his tarnished reputation," Quandt writes. "All his other victories—the Panama treaties, the arms packages—had cost him political support. A peace agreement in the Middle East, by contrast, would be a big plus, even though the process of achieving it might often be painful and time consuming."

It is unlikely the accords would have been achieved without Carter's efforts, Quandt notes. "Carter's role in helping to broker the agreements was central. Left to themselves, [Egyptian President Anwar] Sadat and [Israeli Prime Minister Menachem] Begin would probably not have overcome their suspicions and would have broken off the talks over any number of issues." For both leaders it was easier to accept suggestions from Carter than from each other. Carter's positions on substance also influenced the outcome. He wanted an Egyptian-Israeli agreement on Sinai, and he was prepared to press Begin hard on withdrawal and on settlements to get it. He was less concerned with the details of a West Bank-Gaza agreement and did not think that any explicit linkage with the Palestinian question was desirable or necessary. He deserved much of the credit for the success, and he bore the blame for some of the shortcomings, Quandt observes.

A new test of wills began after Camp David and once again the United States was in the middle. At some risk to his reputation, Carter was prepared once again to gamble to reach an agreement. Again he was successful. In March, 1979, Sadat and Begin signed the Egyptian-Israeli peace treaty in Washington.

For Americans the question remains whether the Egyptian-Israeli treaty could have been followed by successful negotiations involving Jordan, the Palestinians, and Israel. One of the reasons it did not was that Begin succeeded in defining the Camp David Accords in narrow terms, Quandt says. Neither Sadat nor Carter had the will or the power to challenge Begin's interpretation with a more generous one of his own.

A second reason is that the American political system makes it difficult for a president to tackle problems like that of the Palestinians. The issue has proved to be so controversial that most presidents have been reluctant to get deeply involved in it. "The American political system was not designed with the conduct of foreign policy in mind," Quandt observes. One lesson from the Camp David negotiations seems to be that the president can tackle complex foreign policy problems with some chance of success. But, any president will have to do much of the hard work early in his term, for time begins to run out as the election year approaches. These are not "immutable realities," he concludes, "but the Camp David negotiations suggest they cannot be ignored."

A Call for Constitutional Reform

HAS THE TIME come to change the fundamental structure of the United States government? As the Constitution approaches its bicentennial year in 1987, this question is being asked with increasing frequency. Experienced statesmen, scholars, and observers of the government decry the lack of effective, coherent policies to cope with an array of pressing problems — notably the enormous federal budget deficit — and trace the difficulties back to the 200-year-old Constitution. In their view, the unique American "separation of powers," which divides policy-making authority among the presidency, the Senate, and the House, leads to debilitating conflict, stalemate, and deadlock that too often render the government incapable of dealing decisively with domestic problems or of speaking with one voice in foreign affairs. The diffusion of responsibility also makes it difficult for the voters to hold any president or political party accountable for results.

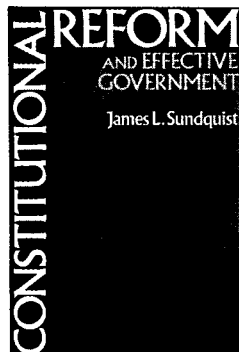
In *Constitutional Reform and Effective Government*, James L. Sundquist reviews past and current debates about whether reform of the Constitution is needed and examines what changes might work best if a consensus should emerge that the national government is too prone to stalemate to meet its responsibilities. Sundquist, a senior fellow emeritus in the Brookings Governmental Studies program, identifies what he considers to be three fundamental weaknesses in the constitutional structure. The electoral system commonly leads to divided control of the executive and legislative branches between the two major parties, making policy conflict and deadlock all but inevitable. The short interval of two years between national elections tends to preoccupy presidents and legislators with the next election and limits to only a few months every four years the "window of opportunity" for dealing with complex matters free of political distraction. Third, no workable mechanism exists for replacing a government that has failed without waiting for the next regularly scheduled election — a delay that can be dangerous to the nation's economy or security.

An ideal series of amendments to the Constitution, Sundquist writes, would include:

—the team ticket, combining each party's candidates for president, vice president,

Constitutional Reform and Effective Government

By James L. Sundquist
\$9.95 paper; \$26.95 cloth.



Senate, and House into a slate that would be voted for as a unit;

- four-year House terms, concurrent with the presidential term, and eight-year Senate terms;
- a method for special elections to reconstitute a failed government, such as the country experienced during the Great Depression and in the Watergate scandal. The special election could be called at any time by the president or a majority of either house of Congress. All seats in both houses, as well as the presidency and vice presidency, would be filled at the election;
- removal of the prohibition against members of Congress holding office in the executive branch;
- a limited item veto that could be overridden by absolute majorities of the two houses, and restoration of the legislative veto;
- a national referendum to break stalemates. Measures that are in deadlock could be submitted to referendum by both houses of Congress, or the president and one house, with the number to be submitted in any year limited to one or two.

Sundquist suggests that reformers consider using two neglected elements of the existing constitutional amendment process. If amendments were presented for state ratification by unicameral conventions rather than by bicameral legislatures, the heavy odds against approval of any proposition by three-fourths of the states would be reduced. The initiation of amendments by constitutional convention rather than by Congress has never been attempted, but it would appear to be the only way that any amendment affecting the powers of the Congress itself could be proposed.

As for the likelihood of these or other fundamental structural amendments to the Constitution ever being adopted, Sundquist is pessimistic. While support exists for some of the recommendations, such as the item veto and lengthening of congressional terms, no widespread public demand exists for a comprehensive reevaluation of the adequacy of the constitutional system. And even if one were undertaken the ratification process demands such an overwhelming consensus that basic changes would be virtually impossible to achieve. "Institutional structure is not an issue likely to arouse popular fervor in the absence of a patent breakdown in the functioning of government," he writes. "Nothing is likely to happen short of crisis—which is, of course, the case with all fundamental constitutional reform, in every country of the world and throughout history."

Reassessing Policy Toward the Third World

*The Struggle for the Third World:
Soviet Debates and
American Options*

By Jerry F. Hough
\$12.95 paper; \$32.95 cloth.

AMERICAN misperceptions of Soviet policy toward the third world have led to missed opportunities for the United States, according to Jerry F. Hough in his new book, *The Struggle for the Third World: Soviet Debates and American Options*. "A new realism about the third world, about the Soviet role there, and about the very nature of international relations is vital," Hough writes. "By failing to develop realistic expectations and rules of the game, the United States is setting the stage for a dangerous and unnecessary crisis sometime in the future."

Hough, a member of the associated staff in the Brookings Foreign Policy Studies program and a professor of political and policy sciences at Duke University, reaches through the elliptical wording of Soviet policy debates to reveal the varied, uncertain, and often contentious views that shape Soviet attitudes toward the underdeveloped countries. He finds the Soviets are reassessing the validity of their most traditional goals and analyses as they confront the reality of developments in the third world.

Central to that reassessment is the Soviets' growing awareness that Western and Japanese economic systems have been stronger models for economic growth in the third world than has been the Soviet system. Radical revolutions

have been occurring only in pre-industrial nations like Afghanistan, Angola, and Nicaragua, while industrializing nations such as Taiwan, Egypt, and Brazil have been moving toward the center or right. As a result, the Soviets are beginning to perceive that a policy concentrated on governmental and economic relations is likely to be more successful in much of the third world than one focused on revolution. Soviet leader Mikhail Gorbachev is already emphasizing the more moderate approach, which is likely to accelerate as Soviet economic reform progresses.

The key to comprehending changes in Soviet policy is "to understand that there is no coherent, uniformly agreed-upon Marxist-Leninist ideology," Hough writes. Official doctrine and the views of Soviet leaders have changed enormously over the past forty years. The old Stalinist orthodoxy is gone. Soviet debates on ideology, strategy, international relations, American policy, and third world developments are important facts in and of themselves. But they also have implications that have not been absorbed in the American understanding of the Soviet Union. Soviet ideology has repeatedly been shaped by events and politics, from the Cuban revolution to an acknowledgement of the difficulty of achieving major growth in countries with a socialist orientation but no oil reserves.

The United States, Hough says, has failed to see that the Soviet position in the third world is worse than it was twenty-five years ago. Because we have "not understood that the Western economic system has been the decisive element in defeating the Soviet Union in the third world, the United States has exaggerated the importance of military force," often overreacting. Nor, Hough says, has the United States "understood the necessity for applying one of the major lessons of the Cuban missile crisis: an adversary who is willing to retreat and make a concession must be given a face-saving way of doing it." This is particularly true with a young leader like Gorbachev, he maintains.

Hough addresses the question of what the United States can do to promote a more reasonable Soviet policy. Any U.S. policy must take into account the one clear-cut interest the Soviet Union has in the third world: to maintain its credibility as a great power. It will not retreat under open, humiliating public pressure. Hough believes that the United States "must follow a very sophisticated policy that avoids either unilateral accommodation or all-out confrontation."

To that end, Americans should become more optimistic about the natural forces at work in the world and rely on them more rather than taking the risks and costs of acting unilaterally. Allies and neighbors will often step in, so that the United States need not always impose the costs itself. Economic sanctions are rarely necessary; banks and private investors will usually withdraw when a country becomes increasingly radical. Informal actions permit a more calibrated response, and much easier change in policy on both sides, than formal governmental action. The United States tends to believe a Soviet success will have a domino effect on neighbors, when international relations theory has always suggested other countries tend to unite to right the balance of power.

So far the United States and Soviet Union have been restrained where vital interests of the other side are involved. Warning that new leaders may not react in the same ways as the old ones, Hough sees potential dangers in areas "where general rules have tacitly been adopted but never clearly defined or emotionally accepted," as in low-level military intervention in Africa by allies of the superpowers. "The most serious problems arise from the lack of clearly defined rules regarding military assistance in areas close to the other's border," he says.

Finally, Hough says, Americans' outdated assumptions about the Soviets in the third world must be rethought, particularly in light of Gorbachev's rise to power in the Soviet Union. A new policy will be difficult for the United States, which has not had a long history of involvement with countries that are equals, has never really accepted conflict in international relations as inevitable, and does not believe other countries' pursuit of their own interests is normal. The ambiguities, for example, in combining cooperation and conflict, under a policy of detente, were very difficult, ultimately too difficult, for American policymakers to accept. And because the United States has been winning the competition with the Soviet Union, change will be all the more difficult. However, with a new policy toward the third world, acknowledging our immense economic strengths, the United States could successfully compete in this new era.

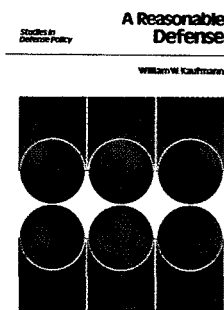


Stronger Defense for Less Money

A Reasonable Defense

By William W. Kaufmann

\$8.95 paper.



IN A NEW BOOK, *A Reasonable Defense*, William W. Kaufmann proposes a defense capability that would be more effective against both nuclear and conventional attacks than either the defense forces President Reagan inherited or those that are projected under his administration for 1992. At the same time, Kaufmann's force would save over \$250 billion in defense outlays by 1990.

Kaufmann's book is the latest in the Brookings series of Studies in Defense Policy. The author is a consultant to the Brookings Foreign Policy Studies program and a member of the faculty of the John F. Kennedy School of Government at Harvard University.

At a time when the debate over budget cutbacks is intensifying, Kaufmann provides the necessary background for understanding the issues by explaining the language of the defense budget, tracing the growth of defense spending from 1929 to the present, and detailing the changes in defense systems and programs made by the Reagan administration. Kaufmann maintains that, despite the political difficulties of doing so, it is in the national interest to have a full-scale review of U.S. strategy, forces, and budgets rather than simply another round of marginal adjustments.

Kaufmann presents a systematic analysis of the return in security the country can expect from alternative investments in defense by comparing the effectiveness of three different U.S. forces in responding to standard planning contingencies.

The first, or baseline, force has the capability that the Reagan administration inherited in 1981, with its performance frozen at 1981 levels but its costs calculated in fiscal 1986 dollars. The second, or programmed, force is the defense force developed by the Reagan administration. Kaufmann assumes that the administration's original program would be fully realized by 1992, at the end of a ten-year modernization plan. The resulting capability reflects a planning approach based on the preferences of the three services.

The third force is the combat force, an artificial construct that removes the main vulnerabilities of the baseline force. It is based on the rule that the life cycle of major weapons averages twenty years, so that upgrading and modernization should be paced to meet that schedule. The assumption behind this force is that, while "previously the United States could meet the uneven challenge from the U.S.S.R. with budgets that, on the average, remained level in real terms, the gradual improvements made in Soviet capabilities during the last twenty years have finally reached the point where U.S. defense budgets from now on (1981) will have to increase moderately in real terms to ensure the main conditions of U.S. security."

In several hypothetical tests, the combat force outperforms the other two forces in both nuclear and conventional conflicts. Crucial ingredients in the success of the combat force are additional ground forces, major increases in the number of Air Force squadrons equipped with close air support aircraft, and the installation of a defense barrier along the inter-German frontier.

Kaufmann examines what has gone wrong in the Pentagon planning process over the past twenty years and offers recommendations for improvements in its efficiency and effectiveness. He emphasizes the harm caused by exaggerations of the Soviet threat, the independence of each service, and the policy of *laissez-faire* at the top of the department. Kaufmann then calls for: an acknowledgment of where the United States stands in the competition with the Soviet Union, reform of the Defense Intelligence Agency and the office of net assessment, revisions in the policy process, and a truly separate staff for the Joint Chiefs of Staff.

Auto Regulation Costs Outweigh Benefits

THE COSTS of programs to regulate automobile safety, fuel economy, and emissions are greater than their benefits, according to the authors of *Regulating the Automobile*. Safety and emissions controls alone add as much as \$1,500 to the purchase price of a new automobile and another \$700 to the current value of operating costs over the lifetime of the car. And because all three programs concentrate solely on new automobiles, consumers postpone replacing dirty, unsafe, gas-guzzling older cars.

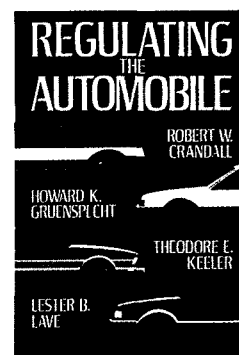
After assessing the costs and benefits of the controls, the authors conclude that only safety regulation appears to be generating benefits at least as great as its costs. Emissions regulation has become far too stringent and fuel economy regulation is a seriously flawed approach to government-mandated energy conservation, which, if desired, could be better achieved through a federal tax on oil. Moreover, regulation has increased Japanese imports by adding to the reliability problems of U.S. automakers, according to the authors: Robert W. Crandall, a senior fellow in the Brookings Economic Studies program; Theodore E. Keeler, professor of economics at the University of California, Berkeley; Lester B. Lave, and Howard K. Gruenspecht, professor and assistant professor of economics, respectively, at the Carnegie-Mellon Graduate School of Industrial Administration.

The authors find considerable evidence that the benefits from safer passenger cars are at least as great as the costs and perhaps substantially greater. They estimate that highway fatalities would be about 40 percent higher were it not for the safety features adopted since the beginning of that program. The authors examine two proposed changes in safety regulation. They advocate an incentive-based insurance policy with fees that reflect the driver's record and demographic characteristics and the actual "crash-worthiness" of the car. They also show that passive restraints could greatly reduce fatalities at a low cost, if motorists do not detach the belts. The higher-cost option, the air bag, may not generate sufficient benefits to justify its installation, they find.

The emissions program was ill conceived, the authors write, and its marginal costs greatly exceed its marginal benefits. It led to a decade of confrontation between Congress and the automakers, imposed large costs on automobile owners, and achieved at best only modest success in its two principal aims: improving air quality and reducing the adverse health effects from air pollution. On average, emissions of new cars do not meet the federal standards. In addition, these cars deteriorate faster than Congress anticipated: their emission rates at 50,000 miles are two to four times higher than the standards.

The authors have several ideas for reform. One is a "two-car approach" to emissions regulations, whereby more stringent standards would be applied to automobiles sold in areas with air quality problems, such as Los Angeles, so that the rest of the country would not have to bear the costs. They suggest that automakers should be able to meet standards on a companywide basis by producing some cars that are cleaner than the standards to compensate for others that exceed the standards. Another approach is to accelerate retirement of old vehicles with high emissions through retirement bounties or high registration fees.

The authors find fuel economy regulation to have been largely irrelevant through 1981 but an obstacle to U.S. automobile producers since then. According to data collected by the Environmental Protection Agency, the fleet-average fuel efficiency of U.S. cars has nearly doubled over 1973–84, but much of that improvement would have occurred without regulation. The Arab oil embargo of 1973–74 would have induced automakers to make more fuel efficient cars in



response to consumer demand. Removing fuel economy regulation would not be a panacea for the domestic industry, but at least it would no longer be a disruptive factor in product planning, the authors conclude. The appropriate mechanism for encouraging conservation would be a federal tax on oil, not a set of technological standards applied to new cars.

Each type of regulation is likely to impose some costs upon automobile producers — either design or production costs — that are reflected in higher auto prices. In this respect, a very tight “technology-forcing” schedule of regulations is likely to be counterproductive for a number of years, greatly reducing vehicle sales and thereby delaying the progress toward cleaner, safer, and more fuel-efficient cars. “When this effect is combined with the impact of tight deadlines on product quality, the result is high-priced problem cars that consumers reject,” the authors write.

The lower quality of and reduced demand for U.S.-produced cars have put downward pressure on automobile industry employment and profits and have led to the imposition of trade restrictions against clean, fuel-efficient Japanese cars and a reduction of the pressure upon Detroit to retool and innovate. “In the last analysis, this protectionism may prove far more costly than the direct compliance costs associated with the three programs analyzed in this volume,” the authors conclude.

They recommend that Congress change underlying legislation and address contradictions between regulatory programs or designate an agency to address them. Above all, steps should be taken to reduce the penalties associated with new cars, perhaps by requiring that existing cars meet new standards. This would promote turnover and satisfy social goals.

Shortcomings of Industrial Policy

PROPOSERS of a more active U.S. industrial policy would be well-advised to examine a case where Washington has tried to promote change — the railroad industry. The federal government has inhibited adjustment by the railroads more often than encouraged it, R. Kent Weaver writes in *The Politics of Industrial Change: Railway Policy in North America*.

Weaver’s study analyzes Canadian and U.S. railroad policies to illustrate industrial policy constraints in the two countries. According to Weaver, a research associate in the Brookings Governmental Studies program, the fundamental constraints are political.

Weaver argues that government policies to accelerate industrial adjustment within individual industries almost always require governments to impose concentrated, visible losses on producer, consumer, and labor groups who are well-organized to resist such moves. Industrial adjustment policies are most likely to be successfully implemented by governments with few veto points, with substantial bureaucratic autonomy and expertise, and with strong government mechanisms to compel compliance, according to Weaver. These characteristics are in short supply in both Canada and the United States, he says.

In the United States, the checks and balances among the executive, legislative, and judicial branches of the federal government and the fragmentation of power within these branches, notably within Congress, make it especially difficult to impose losses on powerful groups. In Canada, intense regional conflicts have similarly made the federal government reluctant to impose losses. As a result, the two governments tend to delay rather than aid industries’ adjustment to changing markets. He concludes that these constraints are so fundamental to the two political systems that neither government has much prospect for improving its ability to help industries adjust in the future.



Weaver also argues that political and economic attributes give nations differing comparative advantages in pursuing particular policies, just as variations in economic resources create comparative advantages in specific industries. Thus, policies that work well in Japan might not work in the United States and Canada. "It makes no more sense for those governments to attempt to imitate Japanese industrial policy than for Floridians to imitate Coloradoans in building ski resorts," he writes.

The history of Amtrak illustrates the shortcomings of federal industrial policy. Amtrak was created in 1970 as the result of a policy impasse between executive branch officials who were determined to avoid long-term federal expenditures for intercity rail passenger service and legislators who sought to avoid the elimination of that service. Congress ultimately mandated incompatible goals for Amtrak: maintaining carrier solvency, preserving service, and easing rail unemployment while minimizing government expenditures. The establishment of Amtrak did not resolve these conflicts; Amtrak continues to operate in an environment of financial uncertainty and dependence, conflicting mandates and controls, and limited discretion, Weaver maintains. Congress has been both the major arena for conflict and an independent source of commands because it calls for specific policy.

"The constraints on accelerationist industrial policy in the U.S. and Canada cannot be removed simply by both governments learning a better way to conduct their business," Weaver concludes. "Fundamental changes would be required in the way that governments and societal interests are organized and function. There is little reason to believe that these deeply ingrained characteristics can be changed in the near future."

Videotape on Corporate Takeovers

In December 1985, a distinguished group of corporate, financial, legal, and government leaders convened in Washington, D.C., to discuss the contentious issue of corporate takeovers. Sponsored by the Brookings Center for Public Policy Education, the National Issues Forum held on corporate takeovers resulted in a day of spirited, frank discussions and the expression of a variety of viewpoints. In an effort to bring these important discussions to as wide an audience as possible, the Brookings Institution has prepared a special 50-minute videotape containing highlights of the day. An outstanding educational resource for corporate management, the legal profession, investment bankers, or anyone concerned about the takeover process, the film is now available for \$395 on either 1/2" (VHS or Beta) or 3/4" videotape.

For further information, please contact Jill Bahcall, The Brookings Institution, 1775 Massachusetts Avenue, N.W., Washington, D.C. 20036, 202-797-6265.



1775 MASSACHUSETTS AVENUE N.W. WASHINGTON D.C. 20036

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED